Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Consumer Federation of America, Petition for Rulemaking	)	RM-9210

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REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

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November 9, 1998

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SUMMARY

U S WEST Communications, Inc. ("U S WEST") hereby submits its reply comments updating and refreshing the record in the various access charge dockets.

First, the evidence submitted by the United States Telephone Association ("USTA") demonstrates conclusively that, using the model utilized by the Federal Communications Commission ("Commission") itself to derive the existing 6.5% productivity factor ("X-Factor"), the X-Factor is considerably too high. Setting the X-Factor too high causes serious harm to the public interest by discouraging investment in the national telecommunications infrastructure, thereby threatening its future viability.

Second, the demands by industry giants AT&T/British Telecom/TCI/TCG ("AT&T") and MCI WorldCom/MFS/Brooks/UUNET ("MCI WorldCom") to reduce interstate access rate by Commission fiat are ultimately anti-competitive and unlawful. Their demands would, if adopted, result in network elements being priced below the realistic cost of constructing facilities. Such artificially low pricing would destroy the profitability of exchange access, thereby eliminating competition from the few remaining competitive local exchange carriers ("CLECs") that have not yet been consumed by AT&T and MCI WorldCom. Once this occurred, AT&T and MCI WorldCom would be well on their way to becoming the sole providers of "one stop shopping" in the profitable business segment of the telecommunications market.

AT&T's and MCI WorldCom's position on the coerced reduction of access prices is premised on a mythical construct called "interstate productivity" and the notion that the competitive market cannot be working because incumbent local exchange carriers ("LECs") are not losing money. However, it is critical to keep in mind that requiring incumbent LECs to calculate their prices in a manner which did not permit them the fair opportunity to recover all the investment and costs assigned to the interstate jurisdiction through separations would not be lawful. It is also important to note that the purpose of this proceeding is not to drive incumbent LECs out of business or to punish them for becoming more efficient under price caps.

Moreover, the assumption that competition is not developing in the interstate access market is demonstrably false. When the state of competition is studied thoroughly and dispassionately, as it was in U S WEST's Phoenix forbearance petition, it is obvious that significant and substantial competition has taken hold in business markets where long distance carriers are forced to compete by market forces. In fact, U S WEST has obtained compelling evidence that, in many markets, its switched access minutes of use are dropping steadily as business customers increasingly migrate to competitive high capacity transport services. There is also extensive evidence showing that, by any measure, competitive providers of interstate access are thriving and experiencing rapid growth.

<u>Third</u>, the interstate access market is sufficiently competitive to justify deregulation and increased pricing flexibility. U S WEST has developed an extensive record in support of its Phoenix forbearance petition showing that the

lucrative business segment of the access market is fully competitive. Specifically, U S WEST submitted a market study, an engineering study and an economic analysis demonstrating the following: (i) the market is highly demand elastic; (ii) competitive providers have constructed extensive fiber networks with which they are capable of capturing a majority of U S WEST's existing demand; (iii) competitive providers have achieved already a 70 percent share of the retail market and are rapidly gaining market share in the facilities provider market; and (iv) U S WEST faces competition from large competitors such as AT&T and MCI WorldCom who enjoy a significant advantage in size and scale economies. Based on this hard evidence, the Commission has all the support it needs to quickly adopt the industry's modest deregulation and pricing flexibility proposal.

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REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

U S WEST Communications, Inc. ("U S WEST") hereby submits its reply comments in response to the Commission's Public Notice of October 5, 1998 requesting that the records in these various access charge dockets be "updated" and "refreshed."[1]

I. THE REPLY COMMENTS OF THE UNITED STATES TELEPHONE ASSOCIATION ("USTA") ARE ACCURATE AND DISPOSITIVE

Much of the comment in this docket has involved technical analysis of the existing price cap model. A study conducted by Dr. Frank Gollop and appended to the comments of the United States Telephone Association ("USTA") demonstrated conclusively that, using the model utilized by the Federal Communications Commission ("Commission") itself to derive the existing 6.5% productivity factor (or

[1] Public Notice, Commission Asks Parties to Update and Refresh Record for Access Charge Reform and Seeks Comment on Proposals for Access Charge Reform Pricing Flexibility, CC Docket Nos. 96-262, 94-1, 97-250, RM-9210, FCC 98-256, rel. Oct 5, 1998.

"X-Factor") used for the annual incumbent local exchange carrier ("LEC") price cap index reductions, the existing X-Factor of 6.5% is considerably too high.[2] USTA, in its reply comments, has submitted additional analysis by Dr. Gollop and others on this key subject. U S WEST endorses this additional analysis and does not duplicate it herein. All credible evidence points to the fundamental conclusions in the initial U S WEST comments: The existing X-Factor is too high and must be decreased, and other efforts by large fully integrated interexchange carriers ("IXCs")/competitive local exchange carriers ("CLECs") to coerce access rate reductions must be rejected.

Particularly important in the USTA filing is the analysis of the existing productivity factor utilized under the price cap regime to drive interstate access prices downward. The USTA comments document perhaps the single most important fact in this proceeding—that further regulatory efforts to drive prices further downward (either through a prescription or an X Factor reduction) would risk causing serious harm to the public. USTA demonstrates that incumbent LEC productivity gains since initiation of price cap regulation have not historically been sufficient to support an X-Factor of 6.5%, and that even maintaining the X-Factor at its current level would risk desiccation of LEC network investment. Of course, AT&T/British Telecom/TCI/TCG ("AT&T") and MCI/WorldCom/MFS/Brooks/UUNET ("MCI WorldCom") insist that the X-Factor be dramatically increased, a position which USTA's comments totally demolish from

[2] See Attachment D, USTA Comments, filed herein.

an economic perspective.

The purpose of these comments is to supplement USTA's analysis. There are critical decisions which the Commission must make, in this docket as well as in other proceedings, which will impact competition, universal service and ultimately the national telecommunications infrastructure. While there is much involved in this docket which calls upon the Commission's expertise, the USTA comments and reply comments point out the crass willingness of AT&T and MCI WorldCom to trash the entire infrastructure in order to increase profits with the help of the regulators.

II. DEMANDS THAT INTERSTATE ACCESS RATES BE REDUCED ARE BASED ON PREMISES WHICH ARE DEMONSTRABLY FALSE, AND ULTIMATELY ANTI-COMPETITIVE AND UNLAWFUL

There is a great deal of fulmination in the initial comments by existing interexchange carriers demanding that interstate access rates be decreased by Commission order. The leaders in this movement are, not surprisingly, AT&T and MCI WorldCom, two of the world's largest telecommunications giants. Naturally, these entities proclaim that any government-required access price reductions will redound to the benefit of consumers,[3] a promise which these same parties have made and broken any number of times in the past.[4] In addition to the USTA analysis, several points bear further thought.

[3] See Comments of AT&T Corp., filed herein, at 7; MCI/WorldCom, Inc. Comments, filed herein at 22.

[4] See USTA Comments at 3, 18-19.

First, it must by now be evident to all that the access price demands made by AT&T and MCI WorldCom are dramatically anti-competitive. Many scholars and commentors already attribute some lag in the growth of facilities-based competition in local exchanges to the misguided pricing rules established by this and other Commissions which priced network elements below the realistic cost of constructing facilities.[5] Such pricing rules simply fly in the face of fundamental economics. If the piece-parts of an incumbent LEC's network are priced too low, it will be economically irrational for a competitor to build its own facilities.[6] Further, policies that are biased toward excessive unbundling or resale will make it difficult for facilities-based competitors to succeed, even assuming they invest in the nation's infrastructure.[7] In the context of the pricing of exchange access, the price demands of AT&T and MCI WorldCom would, if accepted in any conceivable configuration, practically ensure that facilities-based competition in the exchange access market never develops, at least for the less profitable segments of that market.

In the context of AT&T and MCI WorldCom's private interests, this phenomenon is comprehensible. Now that AT&T and MCI WorldCom have already bought up practically all existing CLECs, AT&T has now embarked on an effort to control the alternative "last mile" providers, planning to merge with the country's

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[5] See, e.g., Declaration of Robert W. Crandall at 14-16, attached to Bell Atlantic Comments, filed herein. See also Comments of GTE, filed herein, at 22-24.

[6] See, e.g., Harris and Yao Report, "Federal Implementation of the Telecommunications Act of 1996: Competition in the Local Exchange" at 9-10, attached to Comments of U S WEST, Inc., CC Docket No. 96-98, May 16, 1996.

[7] Id.

largest provider of cable television services.[8] AT&T and MCI are well on the way to becoming the sole providers of "one stop shopping" in the telecommunications market, especially for the profitable business market segments. Facilities-based competitors would simply get in the way of this market strategy. AT&T's and MCI WorldCom's access pricing demands, if accepted by the Commission, would enlist the aid of the Commission in eliminating the few remaining competitors who might stand in the way of their domination of this market.[9] The bottom line is that AT&T and MCI WorldCom have pretty much put an end to the independent CLEC competitive opportunity, and the access price reductions demanded by AT&T and MCI WorldCom would be certain to finish the job. In the absence of CLEC competition, and in the face of the continued legal disability of many of the most significant incumbent LECs to compete because of the Section 271 interLATA restrictions, CLEC disappearance would leave AT&T and MCI WorldCom astride the market with little or no competition. Thus, no matter what rhetoric AT&T, MCI WorldCom and their minions use to support their access rate demands, we submit that the Commission must be aware of the very real, and very anti-competitive, impact of artificially driving rates to the confiscatory levels demanded by AT&T and MCI WorldCom.

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[8] See Application for Authority to Transfer Control of Tele-Communications, Inc., Transferor and AT&T Corp., Transferee. Public Notice, rel. Sept. 29, 1998.

[9] One of the last-remaining independent CLECs, Time Warner, clearly recognizes the dangers posed by the AT&T and MCI WorldCom strategy, and properly opposes Commission-mandated access rate reductions. See Comments of Time Warner Telecom Corporation, filed herein, at 3-9.

Second, once one has cut away the puffery, AT&T's and MCI WorldCom's position on coerced reduction of access prices boils down to two arguments:

- AT&T and MCI WorldCom continue to contend that the price cap productivity analysis must be based on a mythical construct postulated by AT&T and MCI WorldCom called "interstate productivity."[10] Of course, AT&T's and MCI's "measurements" of interstate productivity assume the existence of something which does not exist. Interstate earnings numbers are a product of the separations process, not actual incumbent LEC productivity.
- Dr. Frank Gollop, in his analysis for USTA, documents the only conclusion which can be drawn concerning the AT&T and MCI WorldCom insistence that something which they have made up called interstate productivity is at all meaningful – namely that their argument is simply nonsense. There is no such thing as interstate incumbent LEC telecommunications services, and AT&T's and MCI WorldCom's attempt to convince the Commission otherwise really should have no impact other than to demolish whatever credibility AT&T might otherwise have remaining. A properly calculated X-Factor is neither a game whereby AT&T or MCI WorldCom can play with numbers, nor a method of punishment for incumbent LEC efficiency gains. In fact, even if the economic analysis of AT&T made some sense, one would still wonder at the logic of their insistence that the public interest may be served by the Commission taking investment dollars of incumbent LECs and shoveling them into the coffers of

[10] MCI WorldCom Comments at 27-28; Comments of AT&T at 16-24.

AT&T and MCI WorldCom.

AT&T and MCI WorldCom also rely on false conclusions drawn from incumbent LEC interstate earnings reports as supportive of their position that interstate rates must be reduced. As demonstrated in U S WEST's initial comments and the initial and reply comments of USTA, this contention is both false and dangerous.

In this context, we submit the following information which the Commission might wish to consider in determining whether earnings numbers, reported or not, should be considered as a relevant factor in regulating the prices and rates of interstate carriers:

- AT&T reported that it's 1998 third quarter profit is up 68% over the same quarter a year earlier.
- AT&T's net income was $4.4 billion in 1997, more than 3.7 times that of U S WEST.
- AT&T's net income to date in 1998 is $4.3 billion, thus nearly surpassing its total net income for 1997.
- MCI earned $1.2 billion net income in 1996.
- MCI has reported publicly that its third quarter 1998 revenues were $3.8 billion, an increase of 97% over 1997 revenues for the same period.
- MCI has reported net income of $268 million for third quarter 98. Year to date net income (excluding merger related charges through third quarter 1998) for MCI is $644 million.

This is not to say that the Commission should even consider action to limit AT&T's earnings to levels which it would have the Commission deem reasonable for incumbent LECs—while competition in the interexchange market is far from perfect, there still does not seem to be a reason to regulate the prices charged by

AT&T or MCI WorldCom.[11] But AT&T and MCI WorldComare really asking the Commission to accept the proposition that profit and revenue growth by incumbent LECs demonstrate that neither the market nor price cap regulation are functioning correctly. This proposition is not only economic nonsense, it is belied by AT&T's and MCI WorldCom's own economic performance.

Other than these two arguments, both of which are completely at odds with reasoned decision-making, AT&T and MCI WorldCom have submitted nothing but rhetoric in support of their rate reduction demands.

Third, it is also critical to keep in mind that, even if all of AT&T's and MCI WorldCom's factual allegations were true or meaningful, they would not present a lawful basis on which to order the rate actions which they demand. A federal order directing incumbent LECs to calculate their prices in a manner which did not permit them the fair opportunity to recover all of the investment and costs assigned to the interstate jurisdiction through separations would not be lawful. Should a costing methodology based on forward-looking costs have this result, imposition of such a model on incumbent LECs for ratemaking purposes would likewise be unlawful.[12] In other words, much of AT&T's and MCI WorldCom's

[11] Should the AT&T merger be consummated, regulation of proposed discriminatory access practices will be necessary. See Petition to Deny AT&T/TCI merger, Oct. 29, 1998.

[12] Once incumbent LECs have had the fair opportunity to recover their imbedded investment, ratemaking based on forward-looking costs may indeed become lawful. Of course, ratemaking which relied on costs which were entirely theoretical, such as the HAI model, could never be lawfully imposed. We assume that AT&T and MCI WorldCom use the HAI model in reaching their numbers on what they proclaim to be the "forward looking cost" of providing interstate access. Because

fundamental position is irrelevant because the relief they demand cannot be lawfully implemented.

III. THE POSITIONS TAKEN BY THOSE SEEKING GOVERNMENT-COERCED INCUMBENT LEC RATE REDUCTIONS ARE PUZZLING AND WRONG

A common theme raised by a variety of those seeking to have the Commission coerce lower incumbent interstate access prices is the argument that competition is not appearing in the local exchange market. From this premise, these commenting parties proclaim both that access prices should be reduced by governmental coercion and that efforts to provide incumbent LECs with a measure of regulatory freedom should be shelved.[13] These proclamations are puzzling and to a large extent false.

The first clue that the positions of those who deny the existence of competition are questionable comes from some of the evidence which they proclaim documents anti-competitive activity by incumbent LECs. MCI WorldCom and AT&T, for example, contend that an incumbent LEC's anti-competitive animus can be evidenced by the incumbent LEC's refusal to agree with AT&T or MCI WorldCom on every detail of an interconnection dispute.[14] MCI contends that

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U S WEST continues to have substantial embedded costs, the merits and demerits of the HAI model are irrelevant in any event.

[13] See, e.g., Comments of ACTA, filed herein, at 3-6 and generally Comments of CFA, *et al.* and Consumers Union, filed herein.

[14] See Comments of AT&T at 4; MCI WorldCom Comments at 12-17. This position is particularly galling given some of the positions taken by these parties in interconnection negotiations. AT&T, for example, is the party which had insisted that incumbent LEC repair people attach the incumbent LEC's name to their shirts with Velcro patches so that the AT&T logo could be imposed whenever an AT&T line was being repaired.

the competitive market cannot be working because the incumbent LECs are not losing money—as if true competition should almost by definition result in ruination of the incumbent LECs.[15] The market can be functioning even if incumbent LEC's do not concede to every whimsy of AT&T and MCI WorldCom, and a proper market of necessities includes a profit incentive.

In fact, when the state of competition can be studied dispassionately, as was done in Phoenix in the documents attached to U S WEST's initial comments herein,[16] it is obvious that significant and substantial competition is developing quickly in markets that are attractive to competitors.[17] In the high capacity marketplace examined in the U S WEST study, for example, business users have significant freedom of choice in telecommunications services today.[18] As has been repeatedly documented, the failure of competition to take immediate hold in residential markets (outside of those where the incumbent LEC can currently provide long distance service, in which IXCs are forced to compete by market forces) is generally attributable to a combination of regulatory decisions and IXC reluctance to open the door to a competitive market which would quickly bring

[15] See MCI WorldCom Comments at 9.

[16] See Supplemental Comments and Submissions of U S WEST, attaching Petition of U S WEST for Forbearance, filed herein.

[17] AT&T contend that incumbent LECs are somehow keeping competition out of local exchange markets. To accept this argument, one must assume that incumbent LECs are dedicating their anti-competitive efforts towards protecting their least profitable markets, while leaving their most profitable markets fully open. This is a ludicrous and clearly false proposition.

[18] See Attachment A to Petition of U S WEST for Forbearance, attached to Supplemental Comments and Submissions of U S WEST.

competition to the IXC market as well. Why then is this perception that competition is not developing rapidly so hard to shake? We submit several observations in addition to those already on the record.

A. It Is Not Realistic To Limit Studies Of Competition To "Local Switching"

In reviewing the various submissions, it appears that most commentors who contend that there is no local exchange competition reach their results by measuring what is called "local switching."[19] The theory, long valid, is that the local exchange switch represents an incumbent local exchange bottleneck, and that competition cannot be meaningful unless there is competition for local switching. While more and more observers are recognizing that the so-called "last mile" represents the only real incumbent "essential facility,"[20] it is often assumed that an analysis of local exchange competition which focuses entirely on the local exchange switch presents a valid measurement of competition. Indeed, given the fact that cable television companies currently provide large facilities which duplicate incumbent LEC local loop facilities, it is reasonable to conclude that, if local exchange switching were not a bottleneck, there would be no local exchange bottleneck at all. After all, cable television loop facilities pass almost as many homes as do incumbent LEC loops, and we do not hear AT&T or MCI WorldCom complaining that these alternative loops are being manipulated to the detriment of

[19] <u>See</u>, <u>e.g.</u>, Comments of CompTel, filed herein, at 14-16.

[20] It is not clear that even in this area of traditional essential facility analysis that the incumbent's copper loops represent a true "essential facility" or bottleneck.

competition.[21] In any event, there seems to be a growing consensus that the last remaining "bottleneck," if one exists at all, is in the local switches, not the loops themselves. How, indeed, can the so-called "last mile" of incumbent LEC service be a bottleneck if there are at least two layers to practically every customer?

U S WEST has conducted some additional analysis of local exchange competition which casts doubt on the assumption that local exchange competition can be equated to local exchange switching competition. It appears that much local exchange competition—especially in the interstate arena—entails substituting a service which does not use local exchange switching for traditional local exchange services. Interstate switched access, for example, has long been subject to replacement by alternative transport such as high capacity dedicated transport, especially in the large business segment of the market on the originating end of switched access. However, whenever a competitor substituted high capacity dedicated access service for interstate switched access (be those the facilities of U S WEST or a CLEC), the high capacity dedicated access service normally did not use a local exchange switch. Instead, CPE switching was combined with IXC switching to create the desired communications path. The incumbent LEC's "share"

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[21] Of course, AT&T has just purchased the country's largest cable television provider. AT&T's chairman thereafter immediately gave a speech proclaiming that, in the context of his new purchase of cable television loop plant, application of anything like the FCC's rules which govern incumbent LEC loops and other facilities would be utterly destructive. See Comments of Michael Armstrong at the Washington Metropolitan Cable Club, Nov. 2, 1998, which are summarized, for example, in Reuters News, "AT&T Reiterates Will Not Separate Cable Internet", Nov. 3, 1998. We read the comments of the AT&T chairman as a concession that AT&T has been playing fairly loose with the truth with this Commission for a number of years.

of the switched access market remained the same, but the incumbent LEC had indeed lost business to competition. Competitive measurements based on U S WEST's switching market share would be misleading and affirmatively misstate the state of competition in the marketplace.

A recent study conducted for U S WEST by Quality Strategies, Inc. well documents this point. Attached hereto as Attachment A is the summary from a Quality Strategies "MOU Track" for the Fourth Quarter of 1997—almost a year old. The summary shows that the percentage of access minutes of use ("MOUs") transported within seven U S WEST major markets. In these markets, switched access comprised only 27 to 39% of the total MOUs. Of the remaining MOUs, the vast majority have migrated to high capacity transport services, with CLEC shares of the high capacity services ranging from around 50% in Denver to around 10% in Salt Lake City and Omaha.

We submit that the vast majority of these minutes of use are switched somewhere, and that a claim that the relevant number for measuring competition can be based solely on comparing services where the switching is accomplished within a local exchange would be misleading and unrealistic. In short, for the business customer—the customer which the integrated IXC/CLEC's claim is their primary, if not sole, market focus – the market is already quite competitive. While competitive local switching availability may be relevant in some analytical contexts, the repeated contentions of entities such as AT&T and MCI WorldCom that there is no local exchange competition, and that this assertion is backed up by statistics on local exchange switching, are simply not accurate.

B. AT&T's And MCI WorldCom's Claims That Local Exchange Competition Does Not Exist Are Belied By Their Own Words And Actions

Of perhaps equal significance, when it comes to actions or talking to anyone other than regulators, AT&T and MCI WorldCom tell quite a different competitive story than they have told in their comments before this agency. For example, in the area of switch deployment plans, AT&T and MCI WorldCom are considerably more aggressive than they seem to admit. Attached hereto as Attachment B are excerpts from another Quality Strategies study, this one on switch deployment, dated February of 1998. Although almost a year old, this document too reflects the extent to which AT&T and MCI WorldCom have been deploying local exchange switches. In Phoenix, for example, AT&T currently uses a Lucent 4ESS switch for long distance and intraLATA service, and plans to deploy a Lucent 5ESS switch for local exchange service in the fourth quarter of 1998. MCI plans to use an existing Nortel DMS 500 switch for local and long distance and local exchange service, while WorldCom's February plans called for use of five existing switches plus a new Nortel DMS 500 switch and a Lucent 5ESS switch. In Denver, AT&T has installed a Lucent 5ESS switch in anticipation of offering local service, MCI plans to use existing Siemens Class 5, Class 3 and Class 1 switches for local service, and WorldCom (again, as of February of 1998) planned to use existing Alcatel land Fujitsu frame relay switches plus a planned Nortel DMS 500 switch for other local service. Of course, the fact that AT&T and MCI WorldCom are busy purchasing as many actual and potential providers of competitive local exchange service as possible is entirely consistent with this major effort by these telecommunications giants to assume positions of market power in the one-stop-shopping market for telecommunications services—market power which cannot be gained through competing, but only by the force of government force majeur.

In fact, in their public pronouncements on local exchange competition, as opposed to their statements to this Commission, AT&T and MCI WorldCom (and others) tell a far different story than the Commission has been hearing. Some examples:

WHAT THEY SAY TO REGULATORS

- AT&T: "As of today, competition in the local exchange and exchange access markets remains minimal, and there is no prospect that competition will develop in the foreseeable future that would be substantial enough to drive access charges to economic cost."[22]

WHAT THEY SAY TO WALL STREET

- AT&T: "Compared to first quarter 1998, TCG's (one of several CLEC's acquired by ATT) total revenues for the second quarter 1998 increased by $135.2 million or 84%. Switched access lines added in the second quarter were 66,066 and total access lines in service were 391,940. Domestic local switched services revenue grew 37% from the first quarter 1998 and internal growth in domestic local switched services before the acquisition (of ACC) was a strong 16% quarter over quarter."[23]

[22] Comments of AT&T at 3.

[23] http://www.tcg.com/tcg/investor/fnNews.html.

WHAT THEY SAY TO REGULATORS

- MCI WorldCom: "Eighteen months ago, the Commission determined that substantial exchange access competition would shortly make it unnecessary to prescribe cost-based access charges. Such competition has not materialized."[24]

WHAT THEY SAY TO WALL STREET

- MCI WorldCom: "WorldCom now has local facilities covering areas in which almost 70 percent of the domestic business access lines are located. Furthermore, these local networks are well-placed to serve residential customers in multi-occupant dwellings in over 100 cities."[25]

IV. THE INTERSTATE ACCESS MARKET IS SUFFICIENTLY COMPETITIVE TO JUSTIFY DEREGULATION AND INCREASED PRICING FLEXIBILITY

MCI WorldCom argue that deregulation and pricing flexibility requests should be evaluated following the approach previously used by the Commission to assess market power for other services.[26] The relevant factors are (i) market share, (ii) demand elasticity, (iii) supply elasticity, and (iv) the cost structure of competitors. With the exception of the market share criteria, the MCI position has some validity. In fact, the noted economists Alfred E. Kahn and Timothy J. Tardiff considered these factors in concluding that U S WEST lacks market power in the

[24] MCI WorldCom Comments at 18.

[25] http://www.wcom.com/investor_relations/annual_reports/1997/letter. See also Communications Daily, "Financial Analysts See End to Market Turmoil, New Access to Investments" Oct. 7, 1998, at 4.

[26] MCI WorldCom Comments at 48.

Phoenix Metropolitan Statistical Area ("MSA") market for high capacity special access and dedicated transport for switched access ("high capacity services"). The record that U S WEST has developed in Phoenix –including a market study, an engineering study and an economic analysis – is by far the most complete showing of the competitive landscape in the access market to date.[27] Therefore, it should be given substantial weight by the Commission in this proceeding.

A. Defining The Geographic And Product Markets

MCI WorldCom implies that U S WEST's Phoenix forbearance petition is too narrowly tailored because it seeks nondominant treatment for its high capacity services in one city.[28] There is no doubt that if U S WEST had sought regulatory relief for a broader product and geographical market, opponents such as MCI WorldCom would assert that U S WEST failed to provide specific evidence of competition. In effect, MCI WorldCom wants the Commission to establish a moving target for deregulation so that incumbent requests are always off the mark. U S WEST's forbearance petition is limited in terms of product and geography, but these are not artificial limitations, they are limitations dictated by the market.

U S WEST's petition seeks regulatory relief for the Phoenix MSA because competitors are currently providing service to those parts of the Phoenix MSA which account for the vast majority of high capacity business and can easily expand to other parts of the MSA if economically justified. MCI WorldCom endorses

[27] To update the record, U S WEST is attaching hereto (as Attachment C) a copy of its reply comments filed in support of the Phoenix petition.

[28] MCI WorldCom Comments at 44.

U S WEST's approach later in its comments when its suggests that the Commission analyze pricing flexibility with respect to a metropolitan area, such as an MSA, or contiguous wire centers covering an area roughly comparable to MSA.[29] Thus, U S WEST's petition is entirely consistent with MCI WorldCom's proposal.

U S WEST elected to seek relief for the Phoenix MSA because it was able to accumulate the type of extensive and particularized evidence which the Commission is seeking in support of forbearance petitions.[30] But Phoenix, which is not even the largest city in U S WEST's territory, is not unique.[31] To the contrary, the level of competition that exists in the Phoenix MSA is indicative of the competition that has developed in metropolitan areas throughout U S WEST's territory. Therefore, USTA's proposal calling for deregulation and regulatory relief on an MSA, contiguous MSA, or LATA basis makes good sense.

With respect to the relevant product market, MCI WorldCom acknowledges that for pricing flexibility purposes it may make sense to treat transport and switched access services separately.[32] MCI WorldCom reasons that transport and switched access may constitute distinct product markets because dedicated access is not a "realistic alternative" for most switched access customers. This same

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[29] Id. at 49.

[30] See Order On PCIA Forbearance Petition, WT Docket No. 98-100, Separate Statement of Chairman William Kennard, dated June 23, 1998, at 2 (encouraging parties seeking forbearance to submit "specific showings and particularized evidence so that the Commission can analyze fully whether their requests satisfy each part of the test prescribed by Congress").

[31] Phoenix is the 17^{th} largest MSA in the nation.

[32] MCI WorldCom Comments at 46.

reasoning led U S WEST to identify high capacity services as a distinct market. As Kahn and Tardiff noted, customers for lower capacity facilities would not shift their demands to high capacity facilities in response to a "small but significant" price increase in their current services, because the monthly cost of hooking them up for high capacity access is as much as six or seven times their current basic monthly charges.[33] Thus, high capacity and lower capacity services constitute separate product markets from the customer's perspective.[34]

B. Demand Elasticity

In examining demand elasticity for transport services, MCI WorldCom concedes that such services are typically purchased by interexchange carriers, large businesses, and "other sophisticated users."[35] Kahn and Tardiff found that the sophisticated nature of the purchasers of high capacity services was an important factor in demonstrating high demand elasticity.[36] Indeed, Kahn and Tardiff noted that demand elasticity is probably higher in the market for high capacity services because large IXCs – most notably the combined AT&T and MCI WorldCom companies – now have the option of self-provisioning through their own internal

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[33] Kahn and Tardiff Paper at 11-12.

[34] That is, customers perceive that high capacity and low capacity services are different. The Commission has long held that "like services" are defined by their appearance to the customer. See, e.g., Ad Hoc Telecom. Users Committee v. FCC, 680 F.2d 790, 796 (D.C. Cir. 1982).

[35] MCI WorldCom Comments at 50.

[36] Kahn and Tardiff Paper at 9. As MCI WorldCom notes, the Commission made a similar finding in the AT&T Nondominant proceeding.

CLEC operations.[37] These factors are further reinforced by competitive providers' ability to offer customers sophisticated new services that use high capacity facilities bundled into a complete offering of telecommunications services.[38]

To downplay the demand elasticity of transport services, MCI WorldCom raises the bogeyman of term agreements which it claims prevent customers from switching providers.[39] MCI WorldCom even goes so far as to urge the Commission to force incumbent LECs to waive nonrecurring termination charges and allow customers to simply walk away from their existing agreements.[40] MCI WorldCom greatly exaggerates the effect of term agreements. Consistent with its general approach, MCI WorldCom conveniently neglects to mention that term agreements are commonly used by all competitors in the transport market and that many customers choose not to take advantage of them.[41] Of course, the best evidence that term agreements are not having a negative impact on demand elasticity is the rapid growth of competitors' market share (which is discussed further below).[42] Thus,

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[37] Id. at 10.

[38] Id. at 11.

[39] MCI WorldCom Comments at 50.

[40] Id. at 51.

[41] In Phoenix, approximately half of U S WEST's term agreements will expire within two years, two-thirds will expire within three years, and over 95% will expire within five years. Moreover, over half of U S WEST's agreements have very liberal termination penalties which only require the payment of a 15% termination liability after the first year of service. It should come as no surprise that many competitors routinely agree to reimburse new customers for any termination liability incurred in switching service from U S WEST.

[42] The mere fact that incumbent LECs utilize term agreements demonstrates both the existence of competition and customer cost savings through long-term commitments.

MCI WorldCom's true motivation appears to be the evasion of its contractual obligations.[43]

C. Supply Elasticity

MCI WorldCom argues that supply elasticity is low in the transport services market because there has been "only limited facilities-based competitive entry with circuits terminating to a few buildings in the central business district of larger metropolitan areas."[44] That characterization is certainly not true in the large metropolitan areas within U S WEST's territory. In the Phoenix MSA alone, U S WEST's competitors have deployed over 800 route miles of optical fiber and could serve all of U S WEST's end user and transport traffic at less than eight percent capacity.[45] A majority of U S WEST's existing high capacity demand is located within 100 feet of these extensive fiber networks, which means that it could be absorbed almost immediately at minimal cost.[46] Moreover, as the engineering study submitted by U S WEST demonstrated, competitive providers would not incur significant costs to extend their fiber networks to absorb the vast majority of

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[43] In any event, the Commission could not lawfully allow companies such as MCI WorldCom to back out of their existing term agreements without also requiring them to pay refunds to make up for the lower rates that they received as part of the bargain.

[44] MCI WorldCom Comments at 52. MCI WorldCom also attempts to make an issue of collocation, without mentioning that collocation is not needed to offer competitive alternatives for special access and private line services. Further, competitive providers have collocated in central offices that serve a majority of U S WEST's access lines in the Phoenix MSA. Thus, collocation is not an issue.

[45] U S WEST Petition at 26.

[46] Id. at 26-27.

U S WEST's current high capacity demand.[47] Thus, there is no factual basis for MCI WorldCom's claim that it could not easily acquire the capability to serve additional customers.[48]

In its comments, MCI WorldCom does recognize the importance of the fiber networks that have been deployed in constraining the pricing power of incumbents.[49] As the Commission has recognized, "once competitors have invested substantial costs necessary to participate in the access market, the existence of those facilities will deter the incumbent from raising rates in the future."[50] The five facilities-based competitors in Phoenix already have a great deal of installed capacity. Kahn and Tardiff believe that it is "extremely unlikely" predatory pricing would be successful in the Phoenix market for high capacity services because of the extensive fiber networks that are already in place.[51] Even if U S WEST were able to drive out such unlikely targets for successful predation as MCI WorldCom, it would

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[47] Id. at 27.

[48] MCI WorldCom Comments at 52.

[49] Id. at 54.

[50] Second Further Notice, 11 FCC Rcd. at 925.

[51] Kahn and Tardiff Reply at 12. Kahn and Tardiff conclude "emphatically that it would be simply impossible" for U S WEST to engage in the type of predatory pricing responses to competitive entry that may be occurring in the airline industry. The fundamental difference between the two situations is that incumbent airlines have the ability to temporarily increase their capacity on challenged routes and by so doing force new entrants to pull their equipment out, whereas once new entrants have installed fiber optic facilities, these costs are sunk and the marginal costs are only a small fraction of their total costs." Id. at n.4.

not drive out the facilities that have been installed. Some firm would undoubtedly find it economical to resume operating them in competition with U S WEST.[52]

D. Market Share

Under MCI WorldCom's proposal, competitors would have to achieve a 50 percent market share in terms of revenue or channel terminations between end offices and customer premises before a market could be deemed substantially competitive.[53] The Commission has consistently refused to adopt such a rule which is contrary to good economics. For example, the Commission recently found AT&T to be a nondominant provider of international services despite its high market share in some countries. The Commission concluded that "[AT&T's] high market shares [were] not an obstacle to granting AT&T's motion [for nondominance] in the absence of barriers to entry [that would] prevent AT&T's competitors from continuing to gain market share."[54] Market share is not a relevant test.

Even if it were, MCI WorldCom has wrongly defined market share. U S WEST has already shown that MCI WorldCom is wrong when it argues that market share should be calculated based on revenues rather than capacity. Kahn and Tardiff have supported use of a capacity measure to calculate market share, stating that "[i]n the present instance, involving sales to typically well-informed buyers, it seems unlikely that product differentiation would be determinative:

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[52] Id. at 13.

[53] MCI WorldCom Comments at 55.

[54] In the Matter of Motion of AT&T Corp. to be Declared Non-Dominant for International Service, Order, 11 FCC Rcd. 17963, 17978 ¶ 40 (1996).

modern telecommunications networks are distinguished most fundamentally by their physical ability to transmit information."[55] They also pointed out that using current output (i.e., DS1 equivalents) to calculate market share and not including the total capacity of U S WEST's competitors understates the competitive significance of other providers of high capacity providers in Phoenix.[56]

Another problem with MCI WorldCom's proposal is that focusing only on one market share statistic would not give the Commission an accurate picture of the market. In Phoenix, for example, U S WEST's total share of facilities provided conceals the fact that competitors of U S WEST have already achieved a 70 percent share of the retail market.[57] The retail services provider has a significant marketing advantage over U S WEST because it has the direct account relationship with the customer and can offer bundles of services. In addition, competitive providers' market share has been growing even faster than the impressive 13 percent growth in the demand for high capacity services in Phoenix.[58] Perhaps the most important trend statistic is the fact that, between the second and fourth quarter of 1997, competitive providers captured about half of the growth in demand for high capacity services.[59] Based on these various market share statistics, Kahn and Tardiff concluded that U S WEST has a much stronger case for claiming a lack of market

[55] Kahn and Tardiff Reply at 5.

[56] Id. (emphasis added)

[57] U S WEST Petition at 19.

[58] Id. at 20-21.

[59] Id. at 21.

power in the Phoenix area market for high capacity services than AT&T did when it was declared nondominant.[60]

E. Relative Cost Structures

In discussing relative cost structures, MCI WorldCom raises the concern that new entrants "may not have a sufficient amount of business to achieve economies of scale."[61] While that may be true for some new entrants, it is a laughable assertion in the case of industry giants such as MCI WorldCom and AT&T. Elsewhere in its comments, MCI WorldCom trumpets the fact that it is the "second largest interexchange carrier and the CLEC with the greatest reach and most facilities."[62] The combined MCI WorldCom company has 22 million customers and annual revenues of $32 billion in 1998.[63] Similarly, AT&T recently acquired TCG at a cost of $113 billion and announced its intention to acquire TCI at a cost of $48 billion. The sheer size of these companies dwarfs U S WEST.

Equally as important, the combined MCI WorldCom and AT&T entities control their own competitive fiber networks. This is a significant development, given that MCI WorldCom and AT&T account for approximately half of U S WEST's high capacity business in Phoenix. MCI WorldCom has made it quite clear that its strategy is to deploy a "local-to-global-to-local" phone network that bypasses the

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[60] Kahn and Tardiff at 9.

[61] MCI WorldCom Comments at 56.

[62] Id. at iii.

[63] http://investor.mci.com/merger_overview/merger2.htm.

incumbent LECs.[64] U S WEST is already experiencing the effects of this strategy, as significant portions of these customers' high capacity services have been migrated to the affiliated competitive fiber networks. Kahn and Tardiff observe that "[i]t would be difficult to conceive of a more substantial consequent diminution of whatever market power [U S WEST] might previously have enjoyed.[65]

V. CONCLUSION

For these reasons, the Commission should reject the attempts by giants such as AT&T and MCI WorldCom to line their pockets by raising the 6.5% X-Factor and prescribing access rates based on forward-looking costs. The Commission also

[64] "Merged MCI-WorldCom Begin A 100-Day Sprint," Investor's Business Daily, Sept. 15, 1998, at A10.

[65] Kahn and Tardiff Paper at 6.

should act quickly to implement the modest deregulation/pricing flexibility proposal submitted by USTA.

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U S WEST COMMUNICATIONS, INC.

By: ______________________________

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Dan L. Poole

November 9, 1998

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 9th day of November, 1998, I have caused a copy of the foregoing **REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.** to be served, via first class United States mail, postage prepaid, upon the persons listed on the attached service list.

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Last Update: 11/9/98

ATTACHMENT A

US WEST

MOU TRACK℠

FOURTH QUARTER, 1997

PROPRIETARY AND CONFIDENTIAL

The information contained herein should not be disclosed to unauthorized persons. It is meant solely for use by authorized employees of U S WEST Corporation or any of its subsidiaries.

April 16, 1998

QUALITY STRATEGIES

Washington, D.C.

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QUALITY STRATEGIES
Washington, D.C.
(703) 610-1000

SUMMARY RESULTS AND CONCLUSIONS

TOTAL MOU MARKET COMPOSITION (METROPOLITAN AREAS)

Within U S West's seven geographies, U S West's Switched Access MOUs comprise approximately 23-39% of the Total MOU Market. Competitors' Switched Access MOUs comprise approximately 0-1% of the Total MOU Market.

4Q97	Denver MOUs (000s)	Seattle MOUs (000s)	Portland MOUs (000s)	Minneapolis MOUs (000s)	Phoenix MOUs (000s)	Salt Lake City MOUs (000s)	Omaha MOUs (000s)
MOUs* switched by IXC, transport by USW HICAP	797,092	526,389	276,421	846,838	786,308	429,759	204,221
MOUs switched by IXC, transport by USW / Total Market MOUs	38.0%	44.2%	38.5%	54.4%	44.4%	62.1%	56.1%
MOUs* switched by IXC, transported by CAP/CLEC HICAP	800,495	302,972	189,829	230,444	303,571	36,465	17,266
MOUs switched by IXC, transported by CAP/CLEC HICAP / Total Market MOUs	38.1%	25.4%	26.3%	14.8%	17.1%	5.3%	4.7%
USW Switched Access MOUs**	474,986	345,364	246,829	473,080	662,911	220,456	142,909
USW Switched Access MOUs / Total Market MOUs	22.7%	29.0%	34.2%	30.4%	37.4%	31.8%	38.2%
MOUs** switched by CAP, transported by CAP/CLECs	24,427	16,871	8,415	8,797	18,865	5,447	0
MOUs switched by CAP, transported by CAP/CLECs / Total Market MOUs	1.2%	1.4%	1.2%	0.4%	1.1%	0.8%	0.0%
Total Switched Access MOU Market	2,097,800	1,191,396	721,484	[illegible]	1,771,480	692,527	365,976

*MOUs over HICAP (switched by IXCs) are presented on a monthly basis.

**U S West and CAP/CLEC Switched Access MOUs do not include MOUs over HICAP (which are shown as "switched by IXC") and are presented on a monthly basis.

QUALITY STRATEGIES
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ATTACHMENT B

U S WEST

IXC SWITCH UPDATE

FOURTH QUARTER, 1997

PROPRIETARY AND CONFIDENTIAL

The information contained herein should not be disclosed to unauthorized persons. It is meant solely for use by authorized employees of U S WEST or any of its subsidiaries.

February 3, 1998

QUALITY STRATEGIES.

WASHINGTON, D.C.

U S WEST IXC SWITCH UPDATE 4Q97

DENVER

AT&T SWITCH DEPLOYMENT PLANS

1. Timing for provision of local services:
- AT&T applied to provide local service in Colorado Springs June 21, 1997. They are currently still waiting for approval

2. Plans for use of existing switches:
- AT&T has installed a Lucent 5ESS in anticipation of offering local service

3. Plans for deployment of new switches:
- No new switches will be installed until local service is approved

4. Types of switches planned
- No new switches will be installed until local service is approved

5. Capacity of switches planned:
- 100,000 trunk capacity

6. Targeted service areas:
- Downtown Denver for small, medium and large businesses. The surrounding suburbs will be targeted for residential

DENVER

MCI SWITCH DEPLOYMENT PLANS

1. Timing for provision of local services:

- MCI has facilities in the Denver Tech Center, and will begin providing facilities based local service by 3Q98.

2. Plans for use of existing switches:

- MCI plans to use existing Siemens Class 5, Siemens Class 3, and Siemens Class 1 switches.

3. Plans for deployment of new switches:

- MCI is planning to lease facilities, or interconnect with another network, to provide service in other parts of Denver.

4. Types of switches planned:

- N/A

5. Capacity of switches planned:

- N/A

6. Targeted service areas:

- Currently, MCI has targeted only the downtown Denver area for service. At this time, MCI has 52 buildings on its network. MCI is targeting Mid to Large size businesses.

DENVER

WORLDCOM SWITCH DEPLOYMENT PLANS

1. Timing for provision of local services:
- WorldCom will be providing resold local service August 1998

2. Plans for use of existing switches:
- Alcatel and Fujitsu equipment for frame relay services

3. Plans for deployment of new switches:
- A Nortel DMS 500 will be used to resell local service from U S WEST

4. Types of switches planned
- Nortel DMS 500

5. Capacity of switches planned:
- 91,230 trunks

6. Targeted service areas:
- WorldCom will only service the business section of the downtown metro area for small, medium and large business

ATTACHMENT C

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA	))))	CC Docket No. 98-157

REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

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SUMMARY

U S WEST Communications, Inc. ("U S WEST") hereby submits its reply comments in support of its Petition requesting that the Federal Communications Commission ("Commission") exercise its authority to forbear from regulating U S WEST as a dominant carrier in the provision of high capacity special access and dedicated transport for switched access in the Phoenix, Arizona Metropolitan Statistical Area ("MSA").

Section 10 of the Telecommunications Act of 1996 is a powerful regulatory tool which requires that the Commission remove needless regulation upon a showing of competition in a market. Despite this clear congressional mandate, a number of commenters attempt to introduce a host of irrelevant issues into this proceeding that have nothing whatsoever to do with the merits of U S WEST's Petition. The Commission should ignore these obvious attempts on the part of U S WEST's competitors to delay or sidetrack the granting of regulatory relief.

U S WEST presented extensive evidence in its Petition that the market for high capacity services (i.e., DS1 and above) in the Phoenix MSA is robustly competitive. No party opposing U S WEST's Petition presents any evidence to the contrary or raises any persuasive challenges to the evidence underlying U S WEST's Petition. Indeed, with few exceptions, opponents do not question the validity of U S WEST's market data -- only the meaning of it.

While opponents have conjured up numerous conflicting reasons why U S WEST's Petition has incorrectly defined the relevant product and geographic markets, they have a common objective -- the continued regulation of U S WEST as

a dominant carrier. There is no question that U S WEST's Petition is limited both in terms of product and geographic scope. But these are not artificial limitations, they are limitations that are dictated by the market.

Without evidence, opponents also assert that U S WEST continues to control the market for high capacity services in the Phoenix MSA. Although the opponents dispute the relevance of the retail market share, Alfred E. Kahn and Timothy J. Tardiff conclude that U S WEST's lack of direct contact with sophisticated retail buyers of high capacity services is very important to the question of whether it has market power. U S WEST's total market share also must be considered in the context of the share of new growth that competitive providers captured recently.

Further, no party has challenged U S WEST's evidence that the capacity of existing competitive networks is more than sufficient to absorb all of U S WEST's high capacity business many times over. Although two parties challenge POWER Engineers, Inc.'s ("PEI") estimate of build out costs, PEI refutes these vague and unsubstantiated criticisms. PEI also demonstrates that its estimated build out time would be significantly reduced if competitors focused on the large majority of U S WEST's customer locations located in close proximity to existing competitive fiber networks.

U S WEST's Petition satisfies the statutory criteria for forbearance. First, dominant carrier regulation of U S WEST's high capacity services in the Phoenix area is not necessary to ensure that rates and practices are just, reasonable and not unreasonably discriminatory. Several commenters resort to speculation about possible anti-competitive conduct which Kahn and Tardiff assert is simply inconceivable. In fact, Kahn and Tardiff demonstrate that U S WEST does not have the ability to cross-subsidize or engage in predatory pricing.

Second, dominant carrier regulation of U S WEST's high capacity services in the Phoenix area is not necessary to protect consumers. As with all other carriers, U S WEST will remain subject to Sections 201 and 202 of the Act.

Third, forbearance from applying dominant carrier regulation to U S WEST's high capacity services in the Phoenix area is consistent with the public interest. As the Commission has recognized, the regulation of incumbent LECs and new entrants should be symmetrical in a competitive environment. Kahn and Tardiff identify at least four types of costs imposed by continued dominant carrier regulation of U S WEST in a competitive environment and conclude that these regulatory burdens put U S WEST at a significant disadvantage in the market.

Ultimately, it is the customers who are harmed by the competitive distortions that result from continuing to regulate U S WEST as a dominant carrier in the Phoenix MSA market for high capacity services.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Petition of U S WEST Communications,	)	CC Docket No. 98-157
Inc. for Forbearance from Regulation as a	)	
Dominant Carrier in the Phoenix, Arizona	)	
MSA	)	

REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.

U S WEST Communications, Inc. ("U S WEST") hereby submits its reply comments in support of its Petition requesting that the Federal Communications Commission ("Commission") exercise its authority to forbear from regulating U S WEST as a dominant carrier in the provision of high capacity special access and dedicated transport for switched access ("high capacity services") in the Phoenix, Arizona Metropolitan Statistical Area ("MSA").[1]

I. INTRODUCTION

Section 10 of the Telecommunications Act of 1996 is a landmark statutory provision in the history of telecommunications regulation. For the first time, Congress directed the Commission to remove needless regulation upon a showing of competition in a market. Fundamentally, Congress has made the affirmative decision that competition and market forces are superior to government regulation as a means of making decisions and maximizing consumer welfare.

[1] Petition of U S WEST Communications, Inc. for Forbearance, filed Aug. 24, 1998. Public Notice, DA 98-1712, rel. Aug. 28, 1998; errata, DA 98-2019, rel. Oct. 6, 1998. Comments and oppositions filed Oct. 7, 1998.

Commissioner Michael Powell recently spoke eloquently about the importance of properly using the "powerful" tool of regulatory forbearance to build a competitive market:

> Properly viewed as a decision-making mechanism, it is plain to see that the market is a replacement for regulators making decisions about what services will be offered, what technology will be deployed, by whom, to whom, and at what price. A competitive market, thus, is NOT simply an accumulation of outcomes, pre-selected by the government. We should not yield to its forces only when those outcomes are achieved. . . .
>
> "Getting to competition," then, is not a construction project, as some in policy-making believe, and we are not its master-builders. Instead, I view the drill as handing off decision-making responsibilities to the market. Our work leading up to the change of command is to prepare our institutions for that change, and forbearance is one of the key levers we pull to execute the trade.[2]

Consistent with Powell's vision, U S WEST's Petition asks the Commission to pull the forbearance lever and allow competition to make decisions in the market.

Despite the clear congressional mandate of Section 10, opponents attempt to introduce a host of irrelevant issues that have nothing whatsoever to do with the merits of U S WEST's Petition. MCI WorldCom, Inc. ("MCI/MFS WorldCom"), for example, argues that U S WEST's Petition is "in many respects the functional equivalent of a waiver petition."[3] Starting from this false premise, MCI/MFS WorldCom proceeds to assert that "[i]t is well-established that an applicant for waiver faces a high hurdle even at the starting gate."[4] MCI/MFS WorldCom's feeble

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[2] Remarks (as prepared for delivery) by Commissioner Michael K. Powell before PCS '98, Sep. 23, 1998 at 3 (emphasis in original).

[3] MCI WorldCom at 22.

[4] Id.

attempt to transform a petition filed in accordance with the compulsory forbearance language of Section 10 into a mere waiver request does not warrant a response. Suffice it to say that the statutory criteria of Section 10 are not a "high hurdle" for petitioners, but rather a statutory command which requires the Commission to deregulate where there is a showing of competition.

Ironically, AT&T Corp. ("AT&T") argues that U S WEST should be denied regulatory relief in the Phoenix area market for high capacity services so that U S WEST will have an incentive to reduce prices for all access customers in all geographic areas.[5] This "all or nothing" approach to deregulation is at odds with AT&T's own experience in the long distance market. In particular, the Commission deregulated the business services segment of the long distance market when it found that AT&T faced sufficient competition for most business services,[6] even though the Commission also concluded that AT&T's 800 services, operator services, and international message telephone service were <u>not</u> yet sufficiently competitive to warrant streamlined regulation.[7] Refusing to deregulate those access markets, such as the Phoenix high capacity market, where competition has developed and been documented until it can be shown that all access markets are subject to a similar level of competition would be inconsistent with the Commission's precedent in the AT&T Nondominant proceeding, as well as the plain language of Section 10.

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[5] AT&T at 4.

[6] <u>See</u> <u>In the Matter of Competition in the Interstate Interexchange Marketplace, Report and Order</u>, 6 FCC Rcd. 5880, 5881-82 ¶¶ 8-9 (1991).

[7] <u>Id.</u> at 5905 ¶ 147, 5908 ¶ 165.

MCI/MFS WorldCom asserts that relief in Phoenix must be dealt with in the broader context of the Commission's access charge reform and pricing flexibility docket.[8] However, nothing in the statutory language of Section 10 gives the Commission the authority to delay granting regulatory relief to a petitioner in a competitive market while it addresses broader, industry-wide issues relating to access charges. To the contrary, Congress recognized the urgency of deregulating competitive markets and, therefore, established a one-year statutory deadline for issuing decisions on forbearance petitions. In any event, U S WEST's Petition is consistent with the Commission's parallel effort to implement pricing flexibility in the access market and should guide its decision-making in that proceeding. The Phoenix MSA market for high capacity services provides the Commission with a template for defining the characteristics of a fully competitive access market.

As U S WEST noted in its Petition, AT&T/TCG and MCI/MFS WorldCom are aggressive facilities-based direct competitors with U S WEST in the Phoenix area market for high capacity services.[9] Therefore, it is not surprising that these competitors have employed a variety of tactics in an attempt to delay or sidetrack the granting of regulatory relief. Their own business interests are best served if U S WEST remains handcuffed by regulation and unable to freely compete in the market. However, as the noted economists Alfred E. Kahn and Timothy J. Tardiff conclude, continuing to subject U S WEST to dominant carrier regulation harms customers by depriving them of the attractive prices and product offerings that

[8] MCI/MFS WorldCom at ii, 3, 26-27.

U S WEST could provide with the greater flexibility that would result from nondominant status.[10] The Commission should remain focused on the issues that are legitimately raised by U S WEST's Petition: whether the Phoenix MSA market for high capacity services is competitive and whether the public interest is served by regulating U S WEST in the same manner as all other competitors.

II. OPPONENTS DO NOT CHALLENGE THE VALIDITY OF U S WEST'S MARKET SHARE DATA -- ONLY THE MEANING OF IT

U S WEST presented extensive evidence in its Petition that the market for high capacity services (i.e., DS1 and above) in the Phoenix MSA is robustly competitive. Data compiled by Quality Strategies demonstrates that U S WEST's market share is declining in all sectors of the market and that U S WEST's retail market share is approximately thirty percent. Kahn and Tardiff analyzed Quality Strategies' data and Power Engineering's ("PEI") cost study and concluded that the Phoenix market for high capacity services fully satisfies the Commission's indicia of competition and that U S WEST lacks market power to impose anti-competitive prices or other conditions of service in this market.

In opposing U S WEST's Petition for Forbearance, no party presents any evidence to counter the compelling evidence contained in the Petition. Opponents appear to believe that it is sufficient to endlessly repeat the statement "U S WEST has market power" in the hopes that the Commission will accept this "mantra" in

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[9] Petition at 15-16.

[10] See Attachment A (Alfred E. Kahn and Timothy J. Tardiff, High Capacity Competition in Phoenix: Reply to Comments of Intervening Parties, at n.13, October 28, 1998 ("Kahn and Tardiff Reply")).

place of any contrary evidence. They are wrong. Neither the opponents nor the Commission can ignore the Phoenix market data or the thoughtful analysis of Kahn and Tardiff.

With few exceptions, opponents do not question the validity of U S WEST's market share data.[11] Opponents argue over the relevance of certain data in the Commission's forbearance determination and whether the appropriate geographical market is being analyzed; but they do not challenge the various market data that Quality Strategies compiled for the high capacity market in Phoenix. This is significant and should minimize the work effort involved in the Commission's forbearance determination. For example, the question now becomes what is the significance of a thirty percent retail market share, not what is the level of U S WEST's retail market share. A related question is whether a seventy-nine percent wholesale market share implies dominance regardless of U S WEST's share of the retail market. These questions must be considered in the context of the fifty percent share of new growth captured by competitive providers recently.

[11] GST asserts that U S WEST's data is flawed in that it includes DS-0 circuits. (GST at 15.) U S WEST disagrees. As Quality Strategies explained in its report, it was not possible in collecting market share data to completely exclude DS-0 data from some market segments. Quality Strategies stated that the inclusion of such a small amount of DS-0 data (i.e., approximately 3%) would not appreciably affect market share data. (See Petition at Attachment A, Quality Strategies Report at 11.)

III. THE MARKET FOR HIGH CAPACITY SERVICES IN THE PHOENIX MSA IS THE RELEVANT MARKET FOR FORBEARANCE PURPOSES

Opponents have conjured up numerous conflicting arguments why U S WEST's Petition has incorrectly defined the relevant product and geographic markets. They assert that the Commission should not grant U S WEST's Petition for Forbearance because: (1) the geographic scope of the high capacity market is too limited;[12] (2) the geographic scope of the market is overly-broad;[13] (3) the "high capacity" product is too narrow;[14] (4) the high capacity product market is too broad;[15] and (5) U S WEST has market power in other product and geographical markets,[16] among other things. All of these arguments have a common objective -- the continued regulation of U S WEST as a dominant carrier. Clearly, it is in competitors' self-interest to oppose regulatory relief for U S WEST. Regardless of the lack of merit of these arguments, continued application of the Commission's dominant carrier rules to U S WEST's high capacity services provides competitors with a significant advantage in competing with U S WEST. The Commission should "level the playing field" in this forbearance proceeding.[17]

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[12] Sprint at 4; AT&T at 3.

[13] GST at 8-10; CompTel at 6; MCI/MFS WorldCom at 9.

[14] MCI/MFS WorldCom at 6; AT&T at 4-5; Sprint at 4.

[15] QWEST at 4.

[16] AT&T at 4.

[17] The importance of a level playing field to foster competition was recently recognized by AT&T's own chairman Michael Armstrong at the FCC's October 22, 1998 En Banc Hearing on Mergers. See summary of Armstrong's remarks (transcript of hearing not yet available according to FCC's Internet Homepage) in "Merger Partners Tell FCC That Deals Will Create Competition", Communications

There is no doubt that if U S WEST had selected a broader market in terms of both product and geography, critics would assert that U S WEST failed to provide specific evidence.[18] In preparing this Petition, U S WEST took Chairman Kennard's advice to heart when he "encourage[d] parties seeking future forbearance to submit specific showings and particularized evidence so that the Commission can analyze fully whether their requests satisfy each part of the test prescribed by Congress."[19] There is no question that U S WEST's Petition is limited in terms of product and geographic scope. But these are not artificial limitations, they are limitations that are dictated by the market.[20] In its Petition, U S WEST has provided particularized evidence about a specific market within a clearly defined geographic area, which should allow the Commission to make its determination in a minimal amount of time.

U S WEST continues to believe that the Phoenix MSA is the relevant geographic market for purposes of determining whether it is appropriate for the

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Daily, Oct. 23, 1998. As always, the goal should be to protect competition -- not competitors. Brunswick Corp. v. Pueblo Bowl-O-Mat, 429 U.S. 477, 488 (1977). Also, see Brown Shoe Co. v. United States, 370 U.S. 294, 320 (1962).

[18] See In the Matter of Southwestern Bell Telephone Company Tariff F.C.C. No. 73, Order Concluding Investigation and Denying Application for Review, 12 FCC Rcd. 19311, 19325 at ¶ 27 (1997) ("SWBT Tariff Order") (noting MCI's argument that, to obtain the relief it was seeking, Southwestern Bell had to "prove that competition exists within a defined geographic area").

[19] Order on PCIA Forbearance Petition, WT Docket No. 98-100, Separate Statement of Chairman Kennard, dated June 23, 1998, at 2 ("Statement of Kennard, PCIA Forbearance Order").

[20] As Kahn and Tardiff point out, "the fact that the relevant product market is narrower than the all-local-exchange-services definition proffered by some critics is

Commission to forbear from dominant carrier regulation of high capacity services. Kahn and Tardiff support this position.[21] The fact that competitors are not offering high capacity service throughout the Phoenix MSA on a ubiquitous basis is not a reason for finding that the Phoenix MSA market is too broad for forbearance purposes. Competitors are currently providing service to those parts of the Phoenix MSA which account for the vast majority of high capacity business and can easily expand to other parts of the Phoenix MSA if it is economically justified. As U S WEST's Petition notes, almost half of all U S WEST high capacity locations are within 1,000 feet of a competitive provider's backbone network.[22] In finding AT&T to be a nondominant provider of international services, the Commission concluded "that [the] high market shares [were] not an obstacle to granting AT&T's motion [for nondominance] in the absence of barriers to entry [that would] prevent AT&T's competitors from continuing to gain market share."[23] The same logic applies with respect to the outlying areas of the Phoenix MSA where U S WEST is the primary provider of what little high capacity service exists in these areas.

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richly illustrated by the market behavior of alternative access providers." See Kahn and Tardiff Reply at 2.

[21] Id. at 2. See also, Petition at Attachment C.

[22] These locations account for approximately 86% of all U S WEST's current high capacity demand in the Phoenix area.

[23] In the Matter of Motion of AT&T Corp. to be Declared Non-Dominant for International Service, Order, 11 FCC Rcd. 17963, 17978 ¶ 40 (1996). In making this finding, the Commission found that the countries in which AT&T had a very high market share accounted for less than 0.002% of AT&T's total billed minutes in 1994. Id. ¶¶ 94-97.

U S WEST also takes issue with those opponents who contend the Phoenix MSA is too limited and that the Commission should address these issues in a general access proceeding.[24] The Commission should reject such arguments as at odds with both the requirements of Section 10, as discussed above, and the Commission's desire that petitioners submit "specific showings and particularized evidence."[25] Broadening the geographic area to U S WEST's region surely would fail to satisfy the Commission's test of the relevant geographic market laid out in the Bell Atlantic/NYNEX Order.[26] As Kahn and Tardiff point out, U S WEST's market definition "follows closely the method employed by the antitrust authorities."[27] Furthermore, Section 10 does not give the Commission the discretion to decline to address U S WEST's Petition for the Phoenix MSA and to address similar competitive issues in an industry-wide access proceeding.

U S WEST's petition is narrowly tailored so that it covers only special access and dedicated transport for switched access at DS1 and higher transmission levels.[28] While opponents argue that U S WEST provides a larger share of DS1 service than DS3 service,[29] and that dedicated high capacity circuits used in the

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[24] MCI/MFS WorldCom at ii, 3; AT&T at 4; Sprint at 4.

[25] Statement of Kennard, PCIA Forbearance Order at 2.

[26] See 12 FCC Rcd. 19985, 20016-17 ¶ 54 (1997). The relevant geographic area is defined as "an area in which all customers in that area will likely face the same competitive alternatives for [relevant service]" (citation omitted).

[27] Kahn and Tardiff Reply at 2.

[28] U S WEST is not seeking relief for its xDSL series as alleged by Qwest. Qwest at 4.

[29] AT&T at 7; Sprint at 7; MCI/MFS WorldCom at 7-8.

provision of switched access differ from those used in the provision of special access,[30] they provide no evidence that these are separate markets or on the implied lack of substitutability between these services. There are no close demand substitutes for DS1 and above services[31] and, as such, the Commission should find that these services as a group constitute the relevant market for purposes of its forbearance analysis.

IV. OPPONENTS PROVIDE NO EVIDENCE THAT THE MARKET FOR HIGH CAPACITY SERVICES IN PHOENIX IS ANYTHING BUT ROBUSTLY COMPETITIVE

Without evidence, opponents assert that U S WEST continues to control the market for high capacity services in the Phoenix MSA. They contend that: 1) it is irrelevant for purposes of competitive analysis that U S WEST only has a thirty percent share of the retail market;[32] 2) market shares should be based on revenue, not volume of service;[33] 3) the Herfindal-Hirschman (HHI) indices demonstrate that the Phoenix high capacity market is highly concentrated and, therefore, U S WEST must have market power;[34] 4) U S WEST is able to exercise market power in the high capacity market through control of bottleneck facilities and long-term contracts; and 5) U S WEST has under-estimated both the cost and time for

[30] MCI/MFS WorldCom at 7-8; GST at 15; Sprint at 7.

[31] In the Matter of COMSAT Corporation, File No. 60-SAT-ISP-97; IB Docket No. 98-60; File No. 14-SAT-ISP-97; RM-7913; CC Docket No. 80-634, Order and Notice of Proposed Rulemaking, ¶ 25, (citing LEC Classification Order, 12 FCC Rcd. 15756 ¶¶ 41, 54 (1997).

[32] GST at ii, 13; CompTel at 5.

[33] AT&T at 7; MCI at 19.

[34] Sprint at n.7; GST at 11.

competitors to build out their networks to serve additional buildings in the Phoenix area. Competitors include everything but the "kitchen sink" in their laundry list of arguments to support their joint proposition that U S WEST is a dominant provider of high capacity services and that Phoenix lacks competition. The only thing missing from these arguments is substantiating evidence.

As Kahn and Tardiff demonstrate, retail market share is very relevant to the question of whether U S WEST has market power. "The competitive significance of resellers is that in the presence of alternative suppliers of capacity, resellers can drive hard bargains on the price of that capacity."[35] This is particularly true when the resellers are the likes of AT&T, MCI/MFS WorldCom, and Sprint.[36] The combination of U S WEST's low retail market share, rapidly declining wholesale market share, and large sophisticated buyers such as the large IXCs, results in a market for high capacity services with a high demand elasticity. In such markets,

[35] See Kahn and Tardiff Reply at 6.

[36] While AT&T chooses its words very carefully in hopes of giving the false impression that it is "dependent" on U S WEST and has no alternatives for high capacity services (e.g., "nearly 90% of AT&T's DS1 services are purchased from U S WEST" (AT&T at 7); "on a dollar-weighed basis, AT&T estimates that, as of September 1, 1998, U S WEST collects approximately 80% of the dollars that AT&T spends in the Phoenix LATA on high capacity services." (AT&T at 7-8)), AT&T's actions belie its words. AT&T cannot deny that it is in the midst of a massive project to move as much of its high capacity traffic as possible to TCG, its newly acquired affiliate. The fact that U S WEST still provides a relatively high share of AT&T's DS1 services is not an indication of U S WEST's market power but the fact that AT&T is still largely occupied with moving DS3 and higher services to TCG. Upon completion of this task, AT&T will turn its attention to moving its DS1 traffic to TCG. AT&T's behavior simply demonstrates that the demand for high capacity services in the Phoenix area is highly elastic.

even high market shares in some market segments are not indicative of market power.

On a related note, Sprint and GST contend that nondominant treatment is not appropriate for U S WEST because its overall market share (i.e., seventy-seven percent) results in an HHI index of approximately 6000.[37] This conclusion is unsupported. As Kahn and Tardiff point out:

> First, the antitrust authorities use the HHI as one indicator of whether to approve *mergers* that could lessen competition in an industry. They make no claim that the 1,800 cutoff point is a proper basis for deciding whether or not an industry should be regulated: on the contrary, they would unquestionably reject any such inference. Unregulated industries with HHI's well above 1,800 are far from uncommon. For example, the long-distance industry had an HHI of about 4,000 at the time the FCC granted nondominant status to AT&T. The unregulated central office equipment industry has a similar concentration. In the airline industry, HHIs are high in many markets, because a small number of carriers dominate; yet no serious commentator advocates reregulation of that industry.[38]

Kahn and Tardiff also note that if U S WEST's retail market share of thirty percent is used, it produces an HHI of 1,880, which is indicative of considerably less concentration than existed in the long distance industry when the Commission granted nondominant status to AT&T.[39]

Kahn and Tardiff also take issue with AT&T's and MCI/MFS WorldCom's assertions that U S WEST has incorrectly measured market share. AT&T and MCI

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[37] Sprint at n.7; GST at 11.

[38] Kahn and Tardiff Reply at 7-8.

[39] Id. at 8. Furthermore, HHI alone does not address the existence of market power. Market power is the power to affect price and output. U S WEST does not have market power for high capacity services in the Phoenix MSA because any competitive provider is free to enter the market, and U S WEST's prices currently are regulated.

contend that market share should be calculated based on revenues rather than capacity. Kahn and Tardiff support U S WEST's use of a capacity measure. They note that "[i]n the present instance, involving sales to typically well-informed buyers, it seems unlikely that product differentiation would be determinative: modern telecommunications networks are distinguished most fundamentally by their physical ability to transmit information."[40] They also point out that using current output (i.e., DS1 equivalents) to calculate market share and not including the total capacity of U S WEST's competitors understates the competitive significance of other providers of high capacity service on Phoenix.[41] Thus, rather than understating market share as AT&T and MCI/MFS WorldCom contend, the data in U S WEST's petition seriously overstates U S WEST's market share.

Opponents contend that demand elasticity is limited by U S WEST's control of bottleneck facilities and the fact that U S WEST often provides high capacity services under term agreements.[42] There is no basis for these claims.[43] The existence of numerous CAP/CLEC networks in Phoenix and their close proximity to U S WEST's customers for high capacity services have eliminated whatever bottleneck might have existed in the past for special access services.[44] For dedicated

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[40] Kahn and Tardiff Reply at 5.

[41] Id. at 5.

[42] MCI at 9-10; CompTel at 5; Sprint at 2.

[43] See also, Kahn and Tardiff Reply at note 12 for a discussion of bottleneck control.

[44] Special access and private line are point-to-point nonswitched services. They connect a carrier's point of presence ("POP") to an end user location. They can also be used to connect POPs. Both of these applications are commonly known as special access. These same services are used to connect two or more end user locations, this

transport which is used in the provision of switched access, the situation is somewhat different,[45] but it is a "far cry" from MCI's self-serving, misleading contentions.[46] In order to effectively compete for high capacity services used in the provision of switched access transport, competitors need to be collocated in U S WEST's central offices. Currently, CAPs are collocated in 15 of the 65 central offices in the Phoenix MSA. These central offices account for forty-nine percent of U S WEST's access lines in Phoenix.[47] The fact that MCI has only chosen to collocate in two of these central offices in no way diminishes the competition that U S WEST faces in the provision of switched access transport.

In a similar vein, MCI also grossly mischaracterizes the status of high capacity services subject to term agreements.[48] Currently, approximately twelve

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application is known as private line. Competitors can easily provision any of these applications. They do not need collocation in a U S WEST central office to offer a complete line of competitive alternatives.

[45] Switched access transport is the facility which U S WEST dedicates to an interexchange carrier to deliver the switched access traffic to that carrier's POP from either the end office or the tandem serving the end user. Competition for switched access transport can happen in two ways. First, the carrier (or the competitor) creates a "closet POP" which minimizes the distance U S WEST has to transport the traffic. A competitor transports the traffic from the closet POP, using its facilities, to the POP of the carrier. Second, U S WEST delivers the traffic to collocation space in a U S WEST central office. The competitor transports the traffic to the carrier's POP.

[46] MCI/MFS WorldCom asserts that "[o]f approximately 70 central offices in the Phoenix MSA, only 2 have operational CAP collocations." MCI/MFS WorldCom at 11.

[47] Three additional central offices provide collocation space to CLECs for local interconnection purposes (i.e., the purchase of unbundled loops). In total, these 18 central offices serve 60% of U S WEST's access lines in the Phoenix MSA.

[48] MCI/MFS WorldCom at 9-10.

percent of U S WEST's switched access transport revenues are subject to term agreements while approximately seventy percent of its high capacity special access service revenues are subject to such agreements. Approximately half of these agreements will expire within two years, two-thirds will expire within three years, and over ninety-five percent will expire within five years.[49] Clearly, term agreements do not present a barrier to competition, particularly in a fast-growing market such as the Phoenix MSA.[50]

Another major aspect of the Commission's nondominant inquiry is whether the supply of high capacity services is elastic or inelastic. This inquiry should focus on the ability of competitors to expand to serve U S WEST's customers in Phoenix. As U S WEST noted in its Petition, elasticity of supply is determined both by the amount of unused capacity in competitors' existing networks and their ability to build out their networks to additional locations within a reasonable amount of time.[51]

No party has challenged U S WEST's evidence that the capacity of existing competitive networks is more than sufficient to absorb all of U S WEST's high capacity business many times over. Only MCI/MFS WorldCom and AT&T

[49] Over half of these agreements have very liberal termination penalties which only require the payment of a 15% termination liability after the first year of service. It should come as no surprise that many competitors agree to reimburse new customers for any termination liability incurred in switching service from U S WEST.

[50] Recent expansion of competitive providers' business has been even more rapid than the impressive 13% growth in demand for high capacity services in the Phoenix area market.

[51] Petition at 25-31.

challenge U S WEST's estimate of build out costs.[52] They argue that PEI has under-estimated both the cost and the time to connect additional buildings to competitive networks. MCI/MFS WorldCom feebly attempts to support its arguments by claiming that PEI has failed to include certain critical cost elements and that MCI/MFS WorldCom spends about four times as much as PEI's estimates to connect buildings to its network.[53] Mr. William R. Kopp of PEI disagrees with MCI/MFS WorldCom's assertions and states that PEI's cost study fulfilled its objective of "provid[ing] a reasonable estimate of the 'broad-gauge' costs of constructing connections to a large number of locations."[54] Mr. Kopp notes that PEI's study never was intended to be suitable for "site-specific costs."[55] Mr. Kopp also refutes MCI/MFS WorldCom's contention that PEI failed to include certain costs. Mr. Kopp reiterates that PEI's study "estimates the cost of a large scale build out to extend CAP facilities to duplicate the service level currently provided by U S WEST." In addressing the issue of build out time, Mr. Kopp states that "Power's time estimates were based, [however], on a major construction program in which loops to existing U S WEST locations would be built in the course of a single coordinated effort," rather than on an individual location basis.[56] Mr. Kopp also notes that since a large percentage of U S WEST's high capacity locations are within a 1000 feet and many

[52] MCI at 12-13; AT&T at 10-11.

[53] MCI/MFS WorldCom 12-13.

[54] Attachment B at 1.

[55] Id.

[56] Id.

within 100 feet of CAP networks, the build time would be significantly less than PEI's estimates if competitors focused on these close-in locations.[57]

V. U S WEST'S PETITION SATISFIES THE STATUTORY CRITERIA FOR FORBEARANCE

U S WEST's Petition, which is supported by a marketing study, an engineering report and an economic analysis, clearly satisfies the three statutory criteria for forbearance. In fact, it contains precisely the type of specific showing and particularized evidence called for by Chairman Kennard so that the Commission can verify that a forbearance request satisfies each part of the test prescribed by Congress.[58] The commenters opposing U S WEST's Petition have presented no evidence to the contrary.

First, dominant carrier regulation of U S WEST's high capacity services in the Phoenix MSA is not necessary to ensure that rates and practices are just, reasonable and not unreasonably discriminatory. With one exception, the commenters do not even allege any actual anti-competitive behavior on the part of U S WEST.[59] Rather, several commenters resort to speculation about possible anti-

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[57] Id.

[58] See Statement of Kennard, PCIA Forbearance Order at 2.

[59] TSR Wireless LLC ("TSR"), a one-way paging provider, claims that U S WEST's rates and practices with respect to TSR are unreasonable and discriminatory because U S WEST has refused to provide it with free dedicated T1 facilities. TSR Opposition at 5. The facilities that TSR is referring to are not used to provide interstate special access or dedicated transport for switched access and thus do not fall within the scope of U S WEST's forbearance request. In addition, as TSR acknowledges, the matter is the subject of a pending complaint proceeding as well as a broader proceeding regarding LEC-paging interconnection at the Commission. TSR Opposition at 5-6. For these reasons, the parties' disagreement has no relevance to U S WEST's forbearance Petition.

competitive conduct (i.e., cross-subsidization and predatory pricing) which Kahn and Tardiff assert is "simply inconceivable" given the continued regulation of other services and the presence of competition for high capacity services.[60]

Kahn and Tardiff demonstrate that U S WEST does not have the ability to cross-subsidize prices for high capacity services. Although nondominant regulation of high capacity services in Phoenix could allow U S WEST to raise those prices, it cannot then lower those same prices to predatory levels without losing money.[61] In addition, U S WEST has no unilateral authority to raise prices regulated at the state level.[62]

Moreover, the concern raised by some commenters about the potential for reduced rates in the Phoenix area to produce higher rates in other geographic areas under price caps is unfounded. As GST acknowledges, the Commission established a price cap regime in order to forestall cross-subsidization of unregulated service through increases in regulated services.[63] U S WEST will be removing both the actual demand and corresponding revenue for services subject to nondominant treatment in the Phoenix MSA in such a way as to eliminate any impact on the price of services which remain under price cap regulation. Thus, U S WEST will gain no upward pricing ability or downward pressure for the services that remain under price cap regulation.

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[60] Kahn and Tardiff Reply at 1.

[61] Id. at 12.

[62] Id.

With respect to predatory pricing, the "crucial question" is whether such pricing could drive competitors out of the market for a period that would be sufficient to allow U S WEST to recoup its losses.[64] Kahn and Tardiff believe that it is "extremely unlikely" predation could be successful in this case.[65] The five facilities-based competitive providers in Phoenix already have a great deal of installed capacity. Even if U S WEST were able to drive out such unlikely targets for successful predation as AT&T, it would not drive out the facilities that have been installed. Because extensive competitive fiber networks are already in place, some firm would find it economical to resume operating them in competition with U S WEST.[66]

Those commenters who raise speculative concerns about anti-competitive conduct also mischaracterize the nature of the relief being sought. U S WEST is not requesting that its high capacity services be totally deregulated -- it is seeking only to be regulated as a nondominant carrier in the Phoenix area market for high capacity services. Regulating U S WEST as a nondominant carrier will have no

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[63] GST Opposition at 21 (citing United States v. Western Elec. Co., 993 F.2d 1572, 1580-81 (D.C. Cir.), cert. denied, 510 U.S. 984 (1993)).

[64] Kahn and Tardiff Reply at 12.

[65] Id. at 12.

[66] Id. at 13. Kahn and Tardiff conclude "emphatically that it would be simply impossible" for U S WEST to engage in the type of predatory pricing responses to competitive entry that may be occurring in the airline industry. The fundamental difference between the two situations is that incumbent airlines have the ability to temporarily increase their capacity on challenged routes and by so doing force new entrants to pull their equipment out, whereas once new entrants install fiber optic facilities, these costs are sunk and the marginal costs are only a small fraction of their total costs. Kahn and Tardiff Reply at n.4.

effect on U S WEST's obligations to comply with Section 251(c) of the Act.[67] Nor will it give U S WEST any ability to provide interLATA services that are currently prohibited by Section 271 of the Act.[68] U S WEST is not asking (and indeed could not ask) the Commission to forbear from applying the requirements of Sections 251(c) and 271.[69] Thus, there is no legitimate reason for raising these statutory provisions in connection with U S WEST's Petition.

Second, dominant carrier regulation of U S WEST's high capacity services in the Phoenix MSA is not necessary to protect consumers. MCI/MFS WorldCom claims that, absent regulation, U S WEST would have the ability to "increase prices and distort competition in the interexchange market."[70] This unsupported claim is refuted by the finding of Kahn and Tardiff that competition itself, without dominant firm regulation, is sufficient to restrain U S WEST's ability to impose anti-competitive prices and other conditions.[71] Moreover, MCI ignores the fact that, as with all other carriers, U S WEST will remain subject to Sections 201 and 202 of the Act. The Commission can continue to address any issue of unlawful rates or practices through the exercise of its authority to investigate and adjudicate complaints under Section 208.

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[67] CompTel Opposition at 9.

[68] GST Opposition at 13 n.43. GST subsequently acknowledges that, even if U S WEST is declared nondominant for high capacity services, it still will be at a marketing disadvantage because it will be unable to provide in-region interLATA services. Id. at 14.

[69] 47 U.S.C. § 160(d).

[70] MCI/MFS WorldCom Opposition at 24.

[71] Kahn and Tardiff Reply at 14.

Third, forbearance from applying dominant carrier regulation to U S WEST's high capacity services in the Phoenix MSA is consistent with the public interest. As the Commission has recognized, the regulation of incumbent LECs and new entrants should be symmetrical in a competitive environment.[72] The current asymmetrical regulation of U S WEST in the intensely competitive environment of the Phoenix area market for high capacity services is extremely harmful to the public interest because it deprives consumers of the benefits of new products and services.

AT&T and MCI/MFS WorldCom attempt to downplay the extent to which U S WEST is handcuffed by dominant carrier regulation.[73] However, there simply is no comparison between the limited regulatory relief afforded by density zone pricing and the broad regulatory freedom enjoyed by nondominant carriers. Kahn and Tardiff make the point that "there are competitive benefits from nondominant status that go well beyond pricing flexibility."[74] Kahn and Tardiff also identify at least four types of costs imposed by continued dominant carrier regulation of U S WEST in a competitive environment: (1) the tariff notice period dampens U S WEST's incentive to innovate by allowing competitors to respond to its innovations before they are actually offered; (2) the same notice period dampens U S WEST's incentive to reduce prices; (3) U S WEST's competitors can take advantage of the asymmetrical regulatory process to delay and undermine its

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[72] SWBT Tariff Order, 12 FCC Rcd. at 19337 ¶ 53.

[73] AT&T at 14; MCI/MFS WorldCom at 26.

[74] Kahn and Tardiff Reply at n.13.

initiatives; and (4) regulation imposes administrative costs on both U S WEST and the Commission.[75] At a time when competitors such as AT&T/TCG and MCI/MFS WorldCom are expanding their product offerings to include bundles of services, these regulatory burdens put U S WEST at a significant disadvantage in the market.

Ultimately, it is the customers who are harmed by the competitive distortions that result from continuing to regulate U S WEST as a dominant carrier in the Phoenix MSA market for high capacity services. One such result is "umbrella" pricing, where competitors challenge U S WEST's proposed tariff rates for being unlawfully low while pricing their own services below U S WEST's tariffed rates. Forbearance of the dominant carrier tariff filing requirement would foster true competition in the market by increasing the incentive of all competitors to introduce competitive prices and innovative services. The end result is increased choice for customers.

The Commission itself has recognized that competition, not regulation, is the optimal means of maximizing the public interest. In adopting a market-based approach to access charge restructure, the Commission recognized,

> Competitive markets are superior mechanisms for protecting consumers by ensuring that goods and services are provided to consumers in the most efficient manner possible and at prices that reflect the cost of production. <u>Accordingly, where competition develops, it should be relied upon as much as possible to protect consumers and the public interest.</u> In addition, using a market-based approach should minimize the potential that regulation will create and

[75] <u>Id.</u> at 14.

> maintain distortions in the investment decisions of competitors as they enter local telecommunications markets.[76]

Fundamentally, Section 10 codifies a market-based approach by requiring that, where competition exists, the Commission must remove unnecessary government regulation.

VI. CONCLUSION

Section 10 reflects Congress's reasoned judgment that competition, not government regulation, is the optimal decision-making mechanism in the marketplace. A number of commenters completely miss the mark and treat forbearance as if it is a carrot to be dangled in front of U S WEST or a reward that must be dribbled out slowly over a number of years. That is not what Congress intended. Section 10 is, in fact, a powerful regulatory tool which requires the substitution of market forces for government regulation where there is competition.

U S WEST's Petition asks the Commission to pull the lever of forbearance and rely on competition to maximize the public interest. In support of its Petition, U S WEST's has submitted irrefutable evidence that the Phoenix MSA market for high capacity services is intensely competitive and, therefore, U S WEST does not have the ability to exercise market power. The Petition also satisfies the criteria of Section 10. For these reasons, the Commission should act expeditiously to grant

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[76] In the Matter of Access Charge Reform, 12 RCC Rcd. 15982, 16094 ¶ 263 (1997) (emphasis added).

U S WEST regulatory relief from dominant carrier regulation in the Phoenix MSA market for high capacity services.

Respectfully submitted,

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ATTACHMENT A

HIGH CAPACITY COMPETITION IN PHOENIX: REPLY TO COMMENTS OF INTERVENING PARTIES

Alfred E. Kahn and Timothy J. Tardiff

October 28, 1998

I. INTRODUCTION

Several parties, for the most part U S WEST's competitors in the sale of high capacity services, have protested the Company's request for non-dominant status. They argue that U S WEST continues to enjoy market power, and for this reason has not met the requirements of Section 10 of the Telecommunications Act of 1996. Their conclusions are based upon (1) an overly broad definition of the relevant market, the effect of which is to minimize the competitive inroads into it; (2) understatement of the size of competitors; (3) minimizing the elasticity of demand—specifically, the ease with which customers can (and do) change suppliers; (4) understating the elasticity of competitive supply—the ability of competitors to expand operations; and (5) speculations about anti-competitive conduct (cross-subsidy and predatory pricing) that is simply inconceivable in the face of the continued regulation of other services and the presence of the competition for high capacity services we identified in our opening paper.

Significantly, no party has provided information that contradicts the basic facts we presented. For example, parties have either accepted the market share information we relied upon or offered data that corroborate it.[1] Other purportedly contradictory information that they did present is itself contradicted by their statements elsewhere and/or by their own actions in the market place. For example, both AT&T and MCI Worldcom complain in imprecise terms

[1] AT&T reports that 20 percent of the dollars it spends to acquire high capacity services from others go to U S WEST's competitors. As other commenters have pointed out, the share of expenditures for competitors' services will be lower than their corresponding share of sales volumes (e.g., DS-1 equivalents). Therefore, AT&T's reported 20 percent figure tends to corroborate the Quality Strategies' estimated 23 percent share of sales volumes secured by those competitors.

about the difficulty new entrants face in attracting new customers and in expanding their networks to reach new locations. If the world really were so hostile, one wonders why both firms have spent tens of billions of dollars to acquire firms that have given them a presence in Phoenix and other major cities. While entry into these markets is no doubt challenging, the actions of firms like AT&T and MCI and the growing competition that they have produced speak much more loudly than their advocacy in regulatory proceedings of continued restrictions on one of their major competitors.

II. MARKET DEFINITION

Parties commenting on our definition of the relevant market as confined to high capacity facilities in the Phoenix metropolitan area have suggested that the product market is larger (embracing all local exchange services) and that the geographic market may be smaller (specific point-to-point routes). They have offered no specific criticism of our market definition process, which, as we pointed out in our opening paper, follows closely the method employed by the antitrust authorities. Specifically, our definition of the product market is dictated by the lack of demand response by customers of low- and high-capacity facilities, respectively, to changes in the prices of the other: none of the comments directly contradicts our reasoning on this point, which we would in any event have regarded as self-evident. Our definition of the geographic scope of the market was a practical one, based on the observed entry patterns of competitive carriers.

The fact that the relevant product market is narrower than the all-local-exchange-services definition proffered by some critics is richly illustrated by the market behavior of alternative access providers. For example, according to AT&T's press release issued upon completion of its recent acquisition of Teleport Communications, which greatly strengthened its market position in the offer of exchange access services in Phoenix and elsewhere:

> 'Completion of this merger accelerates our entry into the $21 billion *business* local service market because we're reducing our dependence on the Bell Companies for direct connections to businesses,' said AT&T Chairman C. Michael Armstrong. ... 'We're giving customers simplicity, convenience and

> choice. It's one-stop shopping for local and long-distance service, just for starters,' he said.[2]

Manifestly AT&T views business local services as separate from residential.[3] Since TCG's high-capacity fiber optic network is clearly capable of supplying both "low-capacity" and high-capacity services to that business market, our further delimitation of the relevant market in this case confining it to these latter services was justified not on supply-side considerations but on the non-substitutability of low- and high-capacity services, our exposition of which none of the responders has contradicted.

The incorrect broader market definition proffered by opposing parties would have the effect of inhibiting U S WEST's response to the strong competition of which AT&T itself boasts and which other providers are also offering in Phoenix. While such restrictions would undoubtedly protect AT&T and the others, they would deprive customers of the attractive prices and services that U S WEST would be able to offer if it were accorded the greater flexibility of non-dominant status.[4]

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[2] "AT&T Completes TCG Merger; TCG Now Core of AT&T Local Services Network Unit," AT&T News Release, July 23, 1998, emphasis added. The Release went on to describe how the TCG acquisition facilitates its offer of Digital Link service, an arrangement that employs high capacity links to business customers.

[3] Similarly, MCI WorldCom, following approval of its merger, recently announced a marketing initiative that targets offerings to *business* customers that combine local, long-distance, voice, and data services for calls on its network. "MCI WorldCom Sets Major Marketing Plan for Business Clients," *Wall Street Journal*, September 29, 1998.

[4] One of us has, especially in recent months, strongly propounded the view that some of the responses by incumbent airlines to competitive entry may well have been predatory in both intent and effect. Kahn, "Comments on Exclusionary Airline Pricing," Submission to the Department of Transportation, September 25, 1998. We have therefore explicitly considered the question of whether, if accorded non-dominant status, U S WEST could successfully engage in the same sort of tactic in response to entry by firms such as AT&T and MCI WorldCom—sufficiently to conclude emphatically that it would be simply impossible. It should suffice to demonstrate the fundamental difference between the two situations to point out the vast difference between the resources of incumbent airlines and their upstart challengers—in contrast with the far closer to parity of U S WEST and its major local challengers; and, in a sense even more fundamental, the ability of incumbent airlines greatly to increase their capacity on the challenged routes, temporarily, and by so doing to force the entrants to pull their equipment out, whereas—as we will point out below—the fiber optic facilities of the new entrants in the provision of high capacity service, once installed, are sunk, with marginal costs only a small fraction of their total costs.

III. Competitors Have Captured a Competitively Significant Share of the High Capacity Market

While offering no serious rebuttal to our estimate of the presence and size of alternative high capacity providers in Phoenix, the intervening parties offer different interpretations of the basic facts with the intent of minimizing them. These misleading interpretations include: (1) the argument that market shares should be based on revenues, rather than volumes; (2) the dismissal of U S WEST's small share of the retail market as having any competitive significance; and (3) the presentation of Herfindahl-Hirschman (HHI) indices in an attempt to demonstrate that the Phoenix high capacity market is excessively concentrated.

In addition to their attempt to introduce misleading estimates of the current *level* of competitive presence, they are silent on the rapid *growth* in the market share of U S WEST's competitors. As we pointed out in our opening paper, the CLECs in Phoenix have captured about half of the growth in the rapidly expanding high capacity market.[5] The rapidity of this growth and the CLECs' ability to capture so large a share of it are of greater competitive significance than any static measures of their market share.

A. Measuring Market Shares: Dollar Sales or Physical Volume?

Turning first to the proper basis for calculating market share, the objective in any such calculation is to measure the competitive significance of the smaller firms. In contrast with the critics of U S WEST's previous contentions, Landes and Posner present a compelling case for assessing the competitive significance of challengers by taking into account not just their actual output but their *total physical capacity*:

> ...the sum of the capacity, or potential output, of competitors and the current output of the firm in question should be the denominator in computing the firm's market share. The greater the difference between capacity and current output, the greater is the supply elasticity of competing firms, and therefore the greater

[5] Thus, Sprint's supposition that the high capacity market will contract and firms will exit is grossly inconsistent with recent history and the strong growth of CLECs that we discussed in our opening paper.

> is the constraint that these firms place on a firm that tries to raise price above marginal cost.[6]

The *Horizontal Merger Guidelines* set forth the respective bases for using dollar sales or physical sales:

> Market shares will be calculated using the best indicator of firms' future competitive significance. Dollar sales or shipments generally will be used if firms are distinguished primarily by differentiation of their products. Unit sales generally will be used if firms are distinguished primarily on the basis of their relative advantages in serving different buyers or groups of buyers. Physical capacity or reserves generally will be used if it is these measures that most effectively distinguish firms.[7]

In the present instance, involving sales to typically well-informed buyers, it seems unlikely that product differentiation would be determinative: modern telecommunications networks are distinguished most fundamentally by their physical ability to transmit information. The newer entrants may emphasize lower-priced uses of capacity as an entry strategy. As they become established, however, their full capacity would be available to compete against the incumbent and the other entrants. The implication of these several considerations, we suggest, is that, if anything, our use of market shares defined in terms of current sales, in physical units, without taking into account the *capacity* of the competing providers of high-capacity service in Phoenix, understated their competitive significance.[8]

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[6] William M. Landes and Richard A. Posner, "Market Power in Antitrust Cases," *Harvard Law Review*, Vol. 94, 1981, p. 949.

[7] US Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992, Section 1.41.

[8] Recall that our measure assigned a share of 77 percent of DS-1 equivalents to U S WEST. Landes and Posner (*ibid.*, p. 950) discuss an example in which a firm with 80 percent share lacked market power. In that case, (1) over the previous decade, the firm's share had fallen from 100 percent to 80 percent and (2) further entry and expansion is relatively easy. As our opening paper demonstrated, these characteristics are exhibited likewise by the high capacity market in Phoenix. The reasoning of Landes and Posner would therefore justify the conclusion that U S WEST lacks market power in the sale of these services.

B. Measuring Market Shares. Retail or Wholesale?

In our opening paper, we emphasized U S WEST's shrunken share of the retail market–now under 30 percent. As we pointed out, the competitive significance of this dramatic decline is by no means confined to competition in the sale of high-capacity services alone: the manifest success of U S WEST's competitors in attracting customers for those services clearly foreshadows their probable success in offering the complete range of retail services, combining local, long-distance, voice and data traffic in one package. Moreover, once a competitor such as AT&T and MCI WorldCom captures an end-use customer, it has strong incentives to shift traffic from ILEC facilities to its own network, as we discuss in more detail below. In contrast, intervening parties, primarily the three interexchange carriers (AT&T, MCI, and Sprint), criticize U S WEST's citation of its 30 percent of the retail market as having minimal competitive significance. Their downplaying the critical importance of direct contact with sophisticated retail buyers ignores several critical economic facts that we discussed in our opening paper and review here:

- In its non-dominance proceedings, AT&T's own consultants argued that the 12 percent share of resellers in the long-distance business was sufficient to constrain the pricing behavior of the major IXCs, who collectively held the other 88 percent. The FCC agreed with them. These are the very same IXCs that denigrate the importance of resale in the present case. The competitive significance of resellers is that in the presence of alternative suppliers of capacity, resellers can drive hard bargains on the price of that capacity.
- High capacity buyers are sophisticated business consumers and their retail suppliers, with 70 percent of that retail business, have a growing number of alternative sources of the high capacity inputs they require. Once a retail supplier has attracted a base of customers, it can relatively easily shift its purchases among alternative suppliers of capacity: that is what makes it possible for it to drive hard bargains even in dealing with suppliers that own the major share of the underlying capacity. This bargaining power is of course enhanced by the ability of such successful retailers to

construct their own underlying facilities. The very rationale for acquiring Teleport that AT&T described in the press release from which we have just quoted was to offer its sophisticated customers "one-stop shopping" and to lessen dependence on Bell companies in supplying these services and facilities. There can be no doubt, for example, that AT&T's ability to divert market share at the wholesale level from U S WEST to high capacity facilities formerly owned by Teleport is substantially enhanced by its offer of long-distance (e.g., MEGACOM) and local (Digital Link) services that employ high capacity access. Similarly, MCI WorldCom has clearly stated its intention to migrate access traffic from ILEC networks to its own combined network:

> Part of the rationale for WorldCom's acquiring MCI was that the combined company could meld its networks to create a seamless system for global communications. The largest expense for MCI, as a long-distance carrier, had been fees paid to local phone companies for beginning and ending calls.
>
> MCI WorldCom now wants essentially to eliminate those fees for business customers who use the company for local and long-distance calling. For a conversation or data message that travels exclusively on MCI WorldCom's network, rates could decrease by as much as 35 percent, the company said.[9]

C. Incorrect Applications of HHI Indices

Sprint and GST calculate an HHI index of about 6,000 based on U S WEST's reported share of 77 percent of high capacity volume.[10] Because this result is higher than the value of 1,800 designated by the *Merger Guidelines* as denoting a highly concentrated industry, these parties conclude that non-dominant treatment is not appropriate. Their calculation does not support this conclusion for a number of reasons.

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[9] Seth Schiesel, "FCC Blocks Two Bells on Long-Distance Entry," *The New York Times, September 29, 1998.*

[10] The HHI index is the sum of the squares of the shares of the firms in the market in question. For example, if two firms split a market, the resulting HHI would be 5,000 ($50^2 + 50^2$).

First, the antitrust authorities use the HHI as one indicator of whether to approve *mergers* that could lessen competition in an industry. They make no claim that the 1,800 cutoff point is a proper basis for deciding whether or not an industry should be regulated: on the contrary, they would unquestionably reject any such inference. Unregulated industries with HHI's well above 1,800 are far from uncommon. For example, the long-distance industry had an HHI of about 4,000 at the time the FCC granted nondominant status to AT&T. The unregulated central office equipment industry has a similar concentration. In the airline industry, HHIs are high in many markets, because a small number of carriers dominate; yet no serious commentator advocates reregulation of that industry.

Second, as we have already pointed out, our market share estimate, which is based on DS-1 equivalent sales, understates the competitive significance of CLECs, which would, according to the logic expounded by Landes and Posner, take into account their total capacity. Such a measure would reduce U S WEST's share and the associated HHI.

Third, the HHI for *retail sales* is much much smaller. A market share of 30 percent for U S WEST produces an HHI of 1,880, under the assumption that the remaining 70 percent of the market is evenly distributed over the five competing CLECs. This 1880 figure is of course substantially less than half that of the long-distance market at the time when AT&T requested and the FCC granted it non-dominant status.

IV. ABILITY OF COMPETITIVE SUPPLIERS TO EXPAND

The FCC's previous analysis of nondominant status appraised three separate indicia of the ability of competitors to expand: (1) demand elasticity, (2) supply elasticity, and (3) cost structure and financial capabilities of those competing firms. We made each of these appraisals of the high-capacity market in our opening paper, demonstrating that customers are indeed willing to shift suppliers and that competitors in Phoenix have sufficient ability to meet their demands; and we therefore concluded that this existing and growing competition sufficiently disciplines U S WEST's ability to price anticompetitively as to deprive it of market power in the sale of these services.

In response, the intervening parties suggest specific impediments to competition: (1) long-term contracts, (2) expansion costs higher than those estimated by PEI, and (3) the relatively small size of particular competitors. Our general response is that the opposing parties have generally offered no guidance whatever about the importance and magnitude of the first asserted impediment, and market developments clearly demonstrate that these several asserted factors have not in fact proved to be major barriers to healthy expansion of competition.

With regard to the first asserted barrier, U S WEST estimates that only about 12 percent of its high capacity Switched Access Transport revenues are subject to term agreements, and while approximately 70 percent of its high capacity Special Access service revenues are subject to such agreements, approximately half of these will expire within two years, two-thirds within three years and over 95 percent within five years. The first, 12 percent share is less than the growth in the market in a single year: the other 88 percent is purchased on a monthly basis and therefore up for competitive grabs. As for the Special Access market, and entirely apart from the possibility of inducing customers to cancel their contracts, there is clearly a rough synchronization of the rates at which contracts expire and competitors can construct facilities. The facts that we cited in our opening paper provide powerful testimony to the fact that, despite the (typically short-term) contracts, competitors *are* enjoying a rapidly increasing share in a rapidly growing market. Indeed, we observed, (1) new entrants are capturing about half of the new demand and (2) they have already captured 70 percent of the retail market. No responding parties have offered any information that contradicts these figures. In fact, their actions corroborate our conclusions: we have already cited AT&T's own proclamation that its acquisition of Teleport earlier this year reflected its own expectations that it would by this acquisition be enabled to offer very attractive products to business customers and to be able to shift the provisioning of its requirements from facilities of the Bell Companies.

The supply elasticity story is similar.[11] In spite of the specific obstacles cited by the intervening parties—e.g., gaining access to buildings—the fact remains that CLECs are attracting capital and are expanding at a rapid rate. Clearly, the particular obstacles cited by these intervenors have not deterred either investors or their own managements from providing the funds to expand operations. Again, AT&T's words at the completion of its acquisition of Teleport provide some real-world market perspective on this issue:

> TCG has more fiber route miles and serves more businesses in more cities than any other competitive local service company," Armstrong said. "The strategic value of this merger...positions AT&T for growth and undisputed leadership in three of the fastest growing segments of the communications services industry–consumer, business and wholesale networking services.
>
> TCG, with more than 10,000 miles of fiber optic cable and 50 local switches, is the nation's premier provider of competitive communications services. Its network encompasses more than 300 communities coast to coast. Armstrong said that AT&T also pledges to devote substantial resources to continue the building of facilities in critical markets.

The most detailed discussion of the cost structure and financial capability of competing carriers was provided by GST, the burden of whose comments was that it is much much smaller than U S WEST, as indeed it is. This fact alone has no competitive significance, however: what is relevant is the *combined* capabilities of existing and potential CLECs in Phoenix and their ability to expand their capacities as a group. Paradoxically, GST's figures confirm U S WEST's response to that centrally significant question. For example, GST reports that the combined mileage of its fiber routes alone amounts to only 10 percent of the mileage of U S WEST. Since GST has the smallest network of the CLECs in Phoenix, the combined route coverage of the five CLECs taken together manifestly adds up to a very large fraction of U S WEST's capacity and route miles.

More important are the prospects for growth of existing carriers and new entry. As we discussed in our opening paper, the CLECs are expanding rapidly and having no trouble

[11] MCI WorldCom claimed, without documentation, that its cost of expanding to meet new demand are considerably higher than PEI's estimates. PEI's reply declaration explains why its original cost estimates are reasonable.

attracting capital to fund further expansion. Moreover, even a relatively small firm can exert competitive discipline on a much larger rival. For example, in 1988, Compaq generated only 3 percent of IBM sales, yet its personal computers were highly competitive with IBM's. Today, Compaq's sales are 35 percent as large as IBM's overall and it has surpassed that company in sales of personal computers. The morals of this history lesson are (1) small guys can compete effectively and (2) if they are successful, they grow up to join the big guys.

V. U S WEST HAS NEITHER THE INCENTIVE NOR THE ABILITY TO ENGAGE IN ANTICOMPETITIVE BEHAVIOR

The opponents of U S WEST's petition warn of the twin dangers of cross subsidization and predatory pricing. With regard to the former, the question arises of what prices would be raised to fund the putative anticompetitive behavior. For firms subject to partial regulation, there are three groups of prices that might arguably be increased in order to finance cross-subsidization—prices for services subject to (1) nondominant regulation; (2) federal price cap rules; and (3) state regulation. None of these price increases would be possible under U S WEST's proposal, for reasons we proceed to enumerate.[12]

First, although nondominant regulation of high capacity services in Phoenix could allow U S WEST to *raise* those prices, that would hardly make sense as a means of financing the cross-subsidization of its sales of those same services: the opponents of the regulatory change that U S WEST proposes here can hardly have it both ways—that their fear is, at one and the same time, that when subjected to less stringent regulation, U S WEST would compete unfairly

[12] The intervening parties allude to another asserted competitive problem stemming from U S WEST's asserted control of bottleneck facilities. The first and most critical answer is that U S WEST has no such power in the market in which it requests non-dominant treatment, because this market is competitive. That is, the existence of CLEC facilities and their ability to expand those facilities have eliminated whatever bottleneck existed in the high capacity market in Phoenix. Second, for other markets, bottleneck control presents a problem in the current instance only insofar as it might permit U S WEST to raise its charges for access to those facilities for the purpose of cross-subsidizing its high capacity offerings in Phoenix. As we describe presently, current regulation is sufficiently strong to preclude this possibility. Moreover, it would obviously be irrational and perverse to retain unnecessary and harmful regulation of the high-capacity market in Phoenix, at the expense of consumers there, on the basis of the conception that competition in other local exchange markets is weak. Maintaining unnecessary regulation in the high capacity market on the basis of the state of competition in other local exchange markets would impose unnecessary costs on both U S WEST and Phoenix customers.

with them in the sale of its high-capacity services in Phoenix by at one and the same time reducing those prices and raising them in order to finance those reductions. Nor would it make sense for it to raise the prices of such services, subject to nondominant regulation elsewhere, when the basis for that regulatory change is or would have to be a finding that those prices are sufficiently constrained by competition to prevent raising them in this way.

As for the second possibility—namely, that U S WEST could raise other prices subject to federal price cap regulation--as a matter of simple arithmetic, it would have *less* flexibility to raise those prices if its high capacity services in Phoenix were to be granted nondominant treatment and removed from price caps. This would be so because removal of those services from the price caps would mean that when and if U S WEST exercised its newly conferred freedom to reduce them, it could no longer use those reductions to offset increases in its charges for other price-capped services.[13]

As for the third possible source of cross-subsidy, the simple answer is that these prices are regulated at the state level; U S WEST has no authority to raise them unilaterally.

The fact is that the specter of cross-subsidization is a hobgoblin. To the extent that the putatively cross-subsidizing services are unregulated, U S WEST would presumably have already been setting their prices at the profit-maximizing level; if, then, it decided to exercise its newly conferred freedom to reduce the prices of its high-capacity services in Phoenix, in order to meet competition, there would be no point in its attempting to recover those "losses" by raising the prices of the other services—since there would have been no reason for it not to

[13] The same arithmetic provides the answer to the opponents' concern that U S WEST has not made sufficient use of the price flexibility it has under zone pricing. Use of this flexibility would require U S WEST to lower prices throughout the low-priced zone, not just in those areas competitors have targeted for entry. The loss of revenue in the non-targeted areas is a cost competitors do not face when they reduce prices. Nondominant treatment would eliminate that asymmetry.

In addition, there are competitive benefits from nondominant status that go well beyond pricing flexibility. In a market where its competitors are offering sophisticated new packages, as witnessed by the announcements of both AT&T and MCI WorldCom at the completion of their recent mergers, failure to grant U S WEST similar flexibility in the form of the ability to offer products and change prices with minimal notice would (1) dampen its incentives to offer new products, (2) dampen its incentives to lower prices, and (3) provide its competitors an unfair competitive advantage, because they alone would have advance notice of their major competitor's plans.

have been pricing them at the most profitable level already. To the extent, instead, that the putatively cross-subsidized services were regulated, there is no reason why the regulators of those other services would permit their prices to be increased merely because U S WEST had decided to reduce its prices of newly liberated services in Phoenix.

Turning to predatory pricing, the crucial question is whether such prices could drive competitors out of the market and keep them out long enough for U S WEST to be able to recoup its losses by higher prices after their departure. In fact, it is extremely unlikely predation could be successful. The facilities-based competitors already have a great deal of capacity installed: firms do not exit from markets unless the prices fall and are held below their variable costs; and the very wide gap between total costs and marginal costs of capacity already in place suggests that any attempt at predation would in any event be extremely costly; the predator would have to push prices far below its own total costs and suffer large losses before it would have any hope of driving its rivals from the market. Moreover, even if U S WEST's price reductions drove out such particularly unlikely targets for successful predation as AT&T, they would not drive out *facilities* already installed: the only circumstances under which it would not be profitable for anyone to continue to use those facilities would be if either that continued use were inefficient, because the marginal cost associated with it were higher than the marginal costs incurred by the incumbent, or if the incumbent persisted in pricing its competitive services below its own marginal costs—but for what purpose? Any attempt on its part to recoup those losses by raising rates above competitive levels would not have to be combatted by the construction of new facilities. At that point, because the competing facilities would already be in place, some firm—whether the previous rivals or some successor—would find it economic to resume operating them. In a recent proceeding, the FCC employed almost identical logic in defending its proposal to give ILEC's increasing freedom to offer contractual rates:

> We do not believe that our contract carriage proposal will lead to predatory pricing as such contracts must be made generally available and are typically long term. Further, ... predatory pricing is likely to occur only if a carrier can eliminate competition and continue to deter potential competitors from entering the marketplace. Once competitors have invested substantial sunk costs

necessary to participate in the access market, the existence of those facilities will deter the incumbent from raising rates in the future.[14]

VI. CONCLUSION

In our opening paper, we followed the approach the FCC has previously used to assess market power for other services. Our analysis concluded that the market for high capacity services in the Phoenix area fully exhibits its stipulated indicia of competition. In particular, (1) U S WEST has a diminishing market share—indeed, it serves only 30 percent of the retail market—and is barely providing one-half of the facilities that serve new demand; (2) customers are highly sensitive to price and other dimensions of service; (3) U S WEST's existing competitors can readily expand their capacity sufficiently to displace it entirely, if it were to attempt to price monopolistically, and, in addition, barriers to entry are minimal; and (4) U S WEST's size gives it no insurmountable advantage. Indeed, these indicia all reflect intensifying competition, which strongly suggests that if the FCC grants U S WEST's Petition, there is virtually no likelihood that it will ever regain a dominant position that would call for reregulation. Competition itself, without dominant firm regulation, is sufficient to restrain the Company's ability to impose anti-competitive prices and other conditions.

Although the intervening parties, AT&T and MCI WorldCom prominently among them, have disagreed with our conclusions, their recent actions in the marketplace are entirely consistent with our analysis. In particular, AT&T's recent acquisition of Teleport and the joining of forces of MCI and WorldCom put these firm in a strong position to continue to attract business customers with packages of services that U S WEST cannot yet offer and to divert traffic from ILECs' facilities to its own. In light of these developments, the costs of maintaining dominant firm regulation in this market clearly exceed whatever benefits continued regulation could possibly confer. In particular, as the FCC has noted elsewhere, at a time when

[14] Federal Communications Commission, In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Treatment of Operators Services Under Price Cap Regulation, CC Docket No. 93-124, Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, *Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197*, September 20, 1995, p. 68

competitors such as AT&T and MCI WorldCom are expanding their product offerings, continued dominant regulation of U S WEST imposes the following costs: (1) the longer tariff notices imposed on it dampen its incentives to innovate, because rivals could respond to its innovations even before it could actually offer them; (2) these same filing requirements dampen its incentives also to reduce prices; (3) its competitors can use the asymmetrical regulatory process to delay and undermine its initiatives; and (4) regulation imposes administrative costs on all parties.

ATTACHMENT B

DECLARATION OF William R. Kopp

1. My name is William R. Kopp and my business address is 1295 South Eagle Flight Way, Boise, ID 83709.

2. My position with POWER Engineers, Inc. ("Power") is Project Manager. In that capacity, I supervised the preparation of the Power Engineers Cost Study contained in U S WEST Communications, Inc.'s ("U S WEST") Forbearance Petition for high capacity services in Phoenix, Arizona.

3. I have reviewed the comments that MCI WorldCom, Inc. ("MCI") filed in opposition to U S WEST's forbearance petition. In particular, I am familiar with MCI's criticisms of Power's estimate of the costs of extending CAP facilities to additional buildings.

4. MCI asserts that Power failed to include many critical cost elements and states that its experience indicates that the "true" costs of adding a building to a CAP network should be at least four times greater than Power's estimates. I disagree with MCI's claims. In my opinion, Power's Cost Study met its objective – which was to provide a reasonable estimate of the "broad-gauge" costs of constructing connections to a large number of locations. The Study's Executive Summary states that the cost estimates are "sufficiently accurate for capital budget planning purposes . . . but not suitable for site specific costs." As a result, I would not expect that Power's estimates would be representative of the costs of building-out CAP facilities to any particular building on an individualized basis.

With the exception of a few clarifications that I will provide in this Declaration, Power's Cost Study is self-contained and speaks for itself. The study contains the cost model that Power developed to respond to U S WEST's request along with the underlying assumptions. I believe that the assumptions that were employed are reasonable and that the cost model includes all relevant cost elements.

While MCI is quick to criticize Power's cost estimates, it offers nothing other than the off-hand comment that it spends four times as much to add a building to its network. Needless to say, it is impossible for me to comment on the validity or invalidity of MCI's cost characterizations without more information. However, one must keep in mind that Power's study estimates the minimum cost of a large scale build-out to extend CAP facilities to duplicate the service level currently provided by U S WEST. In other words, what would it cost CAPs to extend their networks to serve U S WEST's existing high-capacity customers and how long would it take. I believe that Power's study does a good job of answering these questions.

5. I will now respond to MCI's specific criticisms:

(a) MCI claims that Power should have included the cost of add-drop multiplexers or other connection nodes in its estimates. I disagree.

As noted in the Study under Assumptions 1 and 3 of Section 4, "Equipment Costs," Power assumed that the competing carrier(s) would be adding to an existing SONET system, in which case initial capital outlays and early-year administrative expenses could be minimized by adding point-to-point systems sized for the initial requirement. For instance, in the case of an initial order for three DS1 channels, only a fiber driver transmit/receive plug set (the point-to-point Quad DS1 system) need be added, at an incremental additional cost.

Power is aware that carriers sometimes place a high capacity SONET system, such as an OC3 (84 DS1's) or OC12 (336 DS1's) at the customer premise upon initial installation of a small number of lower rate channels, such as DS1's. These require a node, such as an add-drop multiplexer to "drop" the required number of DS1 channels from the high capacity system at the location. This increases initial capital outlays and administrative costs (the costs to manage the channels dropped from the system via the multiplexers) but reduces future capital expenditures if the customer adds circuits.

The minimum initial cost approach assumed by Power involves placing a point-to-point system (such as the Quad DS1 system for small numbers of DS1 channels) which does not require a multiplexer at the customer location. Placing a DS-1 add-drop multiplexer for these low volume DS1 requirements would add approximately 30% to the equipment costs.

(b) MCI also claims that Power Engineers failed to include inside wiring costs. These costs were included, but Power inadvertently failed to document these costs in its report. Inside wire costs were estimated as follows:

(i) The length and width of the buildings were measured at each sample location.

(ii) It was assumed that inside cable would be extended for 50% of the length and 50% of the width inside the building.

(iii) It was assumed, for multi-story buildings, that the cable would need to be extended to half the total building height, as an average (Power Engineers did not have data on the floor location or customer name for multi-tenant high rise buildings).

(iv) The inside wiring material costs (cable, support equipment and terminating equipment) were estimated based upon the lengths described above and loaded with estimated labor cost factors.

(c) MCI claims that Power Engineers did not include any building entrance fees. MCI is correct. Power Engineers did not include any such costs because of the wide variety of arrangements and circumstances associated with the assessment or non-assessment of such fees by building owners. Clearly, the presence and bargaining power of major tenants has a significant impact on the behavior of building owners. In those cases where a building is owned by the primary occupant, building entrance fees are much less likely to be assessed regardless of the carrier.

Power did not believe that it could estimate building entrance fees with any degree of accuracy and, therefore, did not include them. Clearly, the assessment of such costs could increase the costs of building-out facilities to some extent.

(d) MCI also takes issue with Power's estimates of the time required to construct facilities. Power stands by its original assessment. As MCI states, if viewed as a single, stand-alone event, building a loop to a given customer location may require three months or more, including engineering time, permit application and approval, and construction.

Power's time estimates were based, however, on a major construction program in which loops to existing U S WEST locations would be built in the course of a coordinated single effort. Power Engineers anticipates that several months may be required from the time the build decision is made until construction on the first loop begins. However, it is Power's expectation that engineering and permit filings for subsequent locations would proceed immediately, parallel in time with the various activities for the first location.

This sequenced, coordinated approach could prevent the time required for engineering and permit application for subsequent locations from inserting serial time delays in the overall construction program.
It should be noted that a large percentage of present U S WEST high capacity customer locations are within 1,000 feet of the nearest CAP fiber optic cable route, and many are within 100 feet. If CAPs focused on these "close-in" locations, the build time could be significantly less than Power estimated for all U S WEST locations.

6. This concludes my declaration.

Pursuant to 47 C.F.R. Section 1.16, I declare under the penalty of perjury that the foregoing is true and accurate to the best of my belief.

Executed this 27th day of October, 1998.

William R. Kopp
Project Manager
POWER Engineers, Inc.

STATE OF IDAHO)
) SS.
COUNTY OF ADA)

On this 23rd day of October, in the year of 1998, before me Sandra M. Gabica, a notary public, personally appeared WILLIAM R. KOPP, personally known to me to be the person whose name is subscribed to the within instrument, and acknowledged to me that he executed the same.

Sandra M. Gabica
Notary Public
Residing at Boise, ID
My Commission Expires 3/7/2000

CERTIFICATE OF SERVICE

I, Rebecca Ward, do hereby certify that on this 28th day of October, 1998, I have caused a copy of the foregoing **REPLY COMMENTS OF U S WEST COMMUNICATIONS, INC.** to be served, via United States Mail,* postage prepaid, upon the persons listed on the attached service list.

Rebecca Ward

Rebecca Ward

*Served via hand delivery

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